Purchases and other expenses

The focus of testing for purchases is completeness, cut-off, occurrence, accuracy and classification.

Sources of evidence:

- Purchase account
- Detailed purchase listing/purchase day book
- Purchase invoices
- Supplier contracts
- Goods received notes
- Purchase orders

Purchases will be understated if all purchase transactions are not recorded, including around the year end.

Purchases will be overstated if goods purchased through the business for personal use are recorded, or purchases which have been returned, are recorded.

Purchases will be misstated if errors are made when recording purchase invoices or if purchases have been misclassified.

Procedures include:

- Inspect GRNs before and after the year end and ensure they have been recorded in the detailed purchase listing in the correct period: **cut-off**.
  In most cases, the company takes ownership for goods when they are received and therefore the purchase expense (and corresponding liability) should be recorded.
- Recalculate discounts and sales tax applied for a sample of purchase invoices: **accuracy**.
- Select a sample of purchase orders and agree these to the GRNs and purchase invoices through to inclusion in the detailed purchase listing: **completeness**.
- Inspect purchase invoices for a sample of purchases/expenses in the detailed purchase listing for the amount, name of the client and description of the goods: **accuracy, occurrence and classification**.

Analytical procedures

- Compare expenses for each category year on year and investigate any significant fluctuations: **cut-off, accuracy, completeness, classification and occurrence**.
- Compare expenses against budget and investigate any significant fluctuations: **cut-off, accuracy, completeness, classification and occurrence**.

- Calculate the gross profit margin and compare with prior year to identify any possible misstatement of purchases. Discuss any significant movement with management: **cut-off, accuracy, completeness, and occurrence**.
- Calculate the operating profit margin and compare with prior year. Investigate any significant fluctuations: **cut-off, accuracy, completeness, classification and occurrence**.

12 Audits of smaller entities

The characteristics of smaller entities can lead to both advantages and disadvantages:

- **Lower risk** – Smaller entities may be engaged in relatively simple activities which reduces risk.
- **Direct control by owner managers** – This can be a strength because they know what is going on and have the ability to exercise real control. However, they are also in a strong position to manipulate the figures or put personal transactions through the business.
- **Simpler systems** – Smaller entities are less likely to have sophisticated IT systems, but pure, manual systems are becoming increasingly rare. This is good news in that many of the bookkeeping errors associated with smaller entities may now be less prevalent. However, a system is only as good as the person operating it.

Evidence implications

- The normal rules concerning the relationship between risk and the quality and quantity of evidence apply, irrespective of the size of the entity.
- The quantity of evidence may be less than for a larger organisation due to fewer transactions occurring.
- It may be more efficient to carry out a fully substantive audit in a smaller organisation.

Problems

- **Management override** – Smaller entities will have a key director or manager who will have significant power and authority. This could mean controls are lacking in the first place or they are easy to override.
- **No segregation of duties** – Smaller entities tend to have a limited number of accounts clerks who process information. To overcome this, the directors should authorise and review all work performed.
- **Less formal approach** – Smaller entities tend to have simple systems and fewer controls due to reliance on trust and lack of complexity. Therefore, less reliance can be placed on internal controls.

13 Audits of Not-For-Profit Organisations

Not-for-profit (NFP) organisations include charities and public sector entities. Below are some important features of a NFP.

- Profit maximisation is not its main objective. Objectives will be either social or philanthropic.
- There are no shareholders.
- Dividends will not be distributed.

Financial statements

NFP organisations, such as charities which are not established as charitable companies, will need to prepare:

- A **statement of financial activities** showing income and expenditure similar to a statement of profit or loss. As the organisation does not exist to make a profit, any additional income over expenditure is known as a surplus and any expenditure in excess of income is a deficit.
- A **balance sheet** showing assets and liabilities, the same as a statement of financial position.
- A **cash flow statement**.
- **Notes to the financial statements**.

Audit risks

Control risk

Some NFP entities, particularly small charities, may have less effective internal control systems due to:

- being controlled by trustees who usually only work on a part-time basis, and are volunteers. Trustees may not devote sufficient time to adequately oversee the strategic direction of the organisation.
- a lack of segregation of duties, as the organisation may not employ many staff in order to keep overheads down.
- the use of volunteers, who are likely to be unqualified and have little awareness of the importance of controls.
- the use of less formalised systems and controls.

Income

With many charities, much of the income received is by way of donation. Some of these transactions will not be accompanied by invoices, orders or despatch notes. For cash donations in particular there is a greater risk of theft.

NFPs may apply for grant income which will only be provided if certain criteria are met. It is likely that if the organisation does not comply with the terms and conditions of the grant, the grant will be repayable. There is a risk that grant income which has to be repaid has not been provided for within current liabilities.

Restricted funds

Some donations are given with clauses stating the money must be used for a particular purpose. For example, money may be donated to a hospital to purchase a specific piece of equipment, or to be used by a specific department. These restricted funds must be shown separately in the balance sheet and the auditor must review donations to ensure that restricted funds are shown as such.

Going concern

Assessing the going concern status of a NFP entity may also be more difficult, particularly for charities who are reliant on voluntary donations. Many issues, such as economic factors, could impact on its ability to generate income in the short-term. Trends can also have an effect. For example, charities raising money for medical research such as cancer and heart disease are seeing higher numbers of donations, whereas charities such as animal protection are seeing a decline in income.

Complexity of regulations

A NFP may have complex internal and external regulations governing its activities, reporting requirements and taxation system. This means the audit team will need to have knowledge of these regulations, and experience of auditing this type of specialised entity, in order to be able to perform the audit with sufficient competence and due care.

Audit testing

Sufficient appropriate evidence will still need to be obtained through either a mixture of tests of controls and substantive procedures, or substantive procedures only if the controls are ineffective or not in place.

Procedures will still involve enquiries, inspection, analytical procedures, etc.

Other planning activities

In addition to the specific audit risks that need to be considered at the risk assessment stage, the same planning activities are required as for the audit of a company. Differences that will require consideration are:

- The materiality assessment may be lower to compensate for the higher risk, therefore more testing may be required.
- The choice of audit team should include staff with experience of this type of entity and knowledge of the regulations and financial reporting requirements.

Reporting

If sufficient appropriate evidence is not obtained with respect to the above matters, as well as the usual risks of material misstatement faced by any organisation, the auditor will have to modify the audit opinion.

Other reporting responsibilities

Quite often, the scope of the external audit of a NFP is much larger than that for a company.

In addition to the financial statement audit, the following may also be required:

- Value for money audit – assessing whether the organisation is getting the most from the money spent. These are discussed in more detail in the chapter 'Internal audit'.
- Regularity audit – ensuring the expenditure of the organisation is in accordance with the regulations/legislation governing it.
- Audit of performance indicators – auditing the targets of the organisation that have to be reported to stakeholders such as waiting times in a hospital accident and emergency department.

e.g

Illustration 6 – Not-for-profit organisation

The Thames Pool Trust (TPT) is a not-for-profit organisation. TPT owns a large area of park space. Within the park is an open-air pool which locals can pay to use. TPT does not employ any staff directly. Day-to-day operations are run by a local organisation, EmCA, under a management agreement, and TPT receives a share of EmCA's operating surplus.

To raise funds to pursue its charitable objective, TPT stages six summer picnic concerts each year. Each event has an audience capacity of 1,200 with a ticket price of $40, and is entirely staffed by volunteers.

Income and expenditure account

	Notes	20X5	20X4
Income:		$000	$000
Share of operating surplus from EmCA	1	49	38
Summer concerts	2	268	275
		–––––	–––––
Total income		317	313
		–––––	–––––
Expenditure:			
Operation of pool	3	(27)	(57)
Summer concerts	4	(242)	(203)
		–––––	–––––
Surplus for year		48	53
		–––––	–––––

Statement of financial position

	Notes	20X5	20X4
		$000	$000
Non-current assets	5	38	55
Current assets:			
Amount due from EmCA		89	102
Cash at bank		877	805
		–––––	–––––
		966	907
		–––––	–––––
Total assets		1,004	962
		–––––	–––––
Funds		1,000	952
Non-current liabilities		4	10
		–––––	–––––
		1,004	962
		–––––	–––––

Notes:

1 Under the management agreement, EmCA submits monthly reports of pool attendance and pool fees received, as well as expense reports. A monthly statement shows TPT's share of EmCA's operating surplus.

2 Income includes ticket sales and the sale of food and drink.

3 Included within pool operation costs are audit fees of $4,000 (20X4: $4,000) and depreciation of $17,000 (20X4: $36,000). The remainder of the costs relate to sundry support costs.

4 Summer concert expenditure includes fees to the bands and the cost of food and drink.

5 The non-current assets note indicates that depreciation expense is the only movement during the year and that the majority of assets are already fully depreciated.

Audit strategy

Audit risk assessment

The greatest risks of material misstatement are:

- Understatement (completeness) of concert income – decreased by $7,000 (2.5%).
- Overstatement of concert expenses – increased by $39,000 (19.2%).

There may be detection risk if adequate accounting records are not maintained for all income and expenditure. For example, if bands are paid cash in hand on the day of the concert there may not be any audit trail for this expense.

Control implications

Controls should be in place to ensure the completeness of income, for example:

- Pre-numbered tickets for each concert.
- Recording issues of concert tickets for sale.
- Requiring the return of unsold concert tickets.
- Reconciling ticket income against the number of tickets sold.
- Only allowing admission by ticket. Tickets should be checked at the gate and once scanned/checked, cannot be used again to gain entry. If ticket sales were allowed on the gate, volunteers may pocket the cash.

- Purchase of items within the concert such as food and drink must be by credit or debit card. No cash should be accepted, to reduce the risk of theft by the volunteers.
- Reconciling pool income recorded to the number of visitors on a daily basis.
- Reconciling pool income recorded to the cash/credit card receipts on a daily basis.

Audit plan

Due to the audit risks identified, the audit approach will be substantive.

Share of operating surplus from EmCA and amounts due from EmCA

- Obtain a breakdown by month of the operating surplus from EmCA, cast and agree to the financial statements.
- Agree the monthly surplus amounts to the breakdown to confirm accuracy.
- Using the monthly reports of pool attendance and fees, calculate the expected income for the pool and compare to the amount included in the financial statements.
- Obtain direct confirmation from EmCA of the amount due.
- Agree after-date cash receipts to the amounts due at the year end.

Income from and expenditure on the summer concerts

- Obtain ticket sale data and multiply by the ticket price to confirm the amount of income recorded.
- Compare income for the current year to the prior year and investigate any significant differences e.g. enquire with management why concert income is 2.5% lower this year and consider whether the explanation is reasonable.
- Perform a reasonable test comparing recorded ticket income with maximum revenue (1,200 × $40 × 6) = $288,000.
- Agree the cost of beverages to purchase invoices to confirm accuracy of recording.
- Calculate mark-up on cost to confirm the completeness of income.
- Compare costs by category to the prior year and investigate any significant differences.
- Inspect invoices to confirm the fees paid to the bands, if available.
- Agree amounts paid to bands to the bank ledger account and bank statements.

Pool operating costs

- Obtain a breakdown of operating costs, cast and agree to the financial statements.
- Agree a sample of costs to invoice, bank ledger account and bank statements.
- Perform analytical procedures by comparing the costs to prior year and investigate any significant differences.

Non-current assets

- Obtain the non-current asset register, cast and agree the total to the financial statements.
- Trace a sample of assets from the NCA register to the physical assets to confirm existence.
- Trace a sample of physical assets through to inclusion in the NCA register to confirm completeness.
- Recalculate the depreciation expense to confirm arithmetical accuracy.

Cash at bank

- Obtain a bank confirmation letter confirming the bank balances at the year end.
- Obtain and cast the bank reconciliation and agree the balance per the bank ledger account to the bank ledger account and financial statements.
- Trace reconciling items on the bank reconciliation to the post-year-end bank statements and pre-year-end bank ledger account.

The procedures above are typical audit procedures that would be used in the audit of a profit making entity. Audits of NFPs are not different to those of a profit making company, however, the audit risks are different due to the nature of the entity.

In addition to the financial statement audit, a value for money audit may be performed to assess whether TPT is getting value for money from the services provided by EMCA. A VFM audit may identify that TFT could obtain a more cost effective service by using another provider or by managing its own activities instead of outsourcing.

Test your understanding 6

(a) **List and explain FOUR assertions that relate to the recording of classes of transactions.**

(4 marks)

(b) **List FOUR assertions relevant to the audit of tangible non-current assets and state one audit procedure which provides appropriate evidence for each assertion.**

(4 marks)

(Total: 8 marks)

Test your understanding 7

You are an audit senior working at a medium sized firm of auditors. One of your clients is an exclusive hotel, Numero Uno, situated in the centre of Big City.

Numero Uno prides itself on delivering a first class dining experience and is renowned for its standards of service and cooking. Its inventory therefore consists of the very best foods and beverages from around the world.

Food products held in inventory are mostly fresh as the head chef will only work with the very best ingredients. Food inventory is stored in the kitchens and managed by the head chef himself.

The majority of beverages held at the hotel are expensive wines that have been sourced from exclusive vineyards. The hotel also stocks a wide range of spirits and mixers. All beverages are stored either in the hotel cellar or behind the bar. The cellar can only be accessed by the duty manager who holds the key. As part of your audit procedures you will attend the year-end inventory count of the hotel's beverages.

Required:

(a) **Describe the audit procedures an auditor would conduct before and whilst attending the inventory count of the beverages in the hotel.**

(7 marks)

(b) Identify and explain THREE financial statement assertions that are most relevant to inventory.

(3 marks)

(c) Apart from attending the inventory count, describe the substantive procedures an auditor would carry out to confirm the valuation of the wine and spirits held in inventory at the year end.

(5 marks)

(Total: 15 marks)

Test your understanding 8

(a) Describe the steps an auditor should take when conducting a trade receivables confirmation (circularisation) test.

(4 marks)

(b) Explain why a direct confirmation test may not provide sufficient appropriate audit evidence on its own.

(3 marks)

You are the audit manager in charge of the audit of Builders Mate, a limited liability company with a year ended 31 March. Builders Mate has been an audit client for three years. Builders Mate sells small tools, plant and equipment exclusively to the building trade. It has 12 warehouse style shops located throughout the country. Builders Mate does not manufacture any products.

The audit fieldwork is due to commence in 3 weeks' time and you are preparing the audit work programme for the trade receivables section of the audit. Extracts from the client's trial balance show the following information.

	$
Trade receivables account	124,500
General trade receivables allowance	(2,490)
Specific trade receivables allowance	0

From your review of last year's audit file you have determined that last year there were 2 specific allowances of $5,000 and $2,000 as well as a 3% general allowance.

Initial conversations with the client indicate that there are no specific allowances to be made this year, however, the general allowance will be reduced from 3% to 2%.

You are aware that two of Builders Mate's major customers went into administration during the year and they are likely to be liquidated in the near future. Both of these customers owed material amounts at the year end.

Required:

(c) Describe substantive procedures the auditor should perform on the year-end trade receivables of Builders Mate.

(9 marks)

(d) Describe how audit software could facilitate the audit of trade receivables.

(4 marks)

(Total: 20 marks)

Test your understanding 9

You are auditing the revenue section of the financial statements of Ningaloo Co. Internal controls have been evaluated as effective. Substantive procedures have not yet been performed. During the risk assessment you identified that a performance related bonus has been introduced for salesmen who reach a target sales figure each quarter.

1 **Which of the following statements is correct?**

A As controls are working effectively within Ningaloo Co the audit plan does not need to contain any substantive procedures as full reliance can be placed on the control system

B The auditor will perform the same level of substantive procedures as were performed in the prior year

C The level of substantive procedures may be reduced as a result of the controls being found to work effectively

D The level of substantive procedures should increase if controls are found to be working effectively

2 **'Select a sample of goods despatch notes from just before and just after the year end and trace to the detailed sales listing'. Which financial statement assertion is addressed by this audit procedure?**

A Occurrence

B Completeness

C Cut-off

D Accuracy

3 **Which of the following statements is correct with regard to directional testing?**

A A procedure that directly tests receivables for overstatement will indirectly test revenue for understatement

B A procedure that directly tests receivables for overstatement will indirectly test revenue for overstatement

C To test revenue for overstatement the auditor must choose a sample from outside of the accounting system, such as GDNS, and trace them into the accounting system

D To test revenue for understatement the auditor must choose a sample from within the accounting system and trace it to the GDN

4 **Which of the following is an analytical procedure that can be used to test revenue?**

A Comparison of revenue in the current year to revenue in the prior year

B Review of credit notes issued post year end

C Inspection of a sample of goods despatch notes and sales invoices

D Recalculation of the detailed sales listing

5 **Sales managers have recorded fictitious sales in order to earn a larger bonus. Which of the following assertions is affected by this?**

A Existence

B Completeness

C Accuracy

D Occurrence

Test your understanding 10

You are performing procedures over the non-current assets balance for your client Leveque Co. The balance consists of motor vehicles, fixtures and fittings and land and buildings. Motor vehicles are replaced on a three-year cycle. Fixtures and fittings are replaced as and when required. The company uses the following depreciation rates:

- Land and buildings – no depreciation is charged due to values increasing
- Fixtures and fittings – 10% straight line
- Motor vehicles – 20% straight line.

1 **Which of the following best describes the audit risk resulting from the depreciation policy used for land and buildings?**

A Land and buildings may not exist

B Land and buildings may not be completely recorded

C Land and buildings may be understated

D Land and buildings may be overstated

2 **Which of the following procedures provides the most reliable evidence to assess whether 10% straight line is an appropriate rate for fixtures and fittings?**

A Enquire of the client whether the rate is appropriate and how they chose that rate

B Contact the supplier of the fixtures to ask how long the fixtures should last

C Review disposals of fixtures and fittings to identify how long the assets had been used by Leveque Co and whether any significant profit or loss on disposal arose

D Compare the rate with other audit clients of your firm

3 **Which of the following statements is true in respect of Leveque's motor vehicles?**

A The depreciation rate is unreasonable as the company only uses the assets for three years therefore depreciation should be charged over three years

B Motor vehicles have a useful life of longer than five years therefore depreciation should be charged over a longer period

C The depreciation rate is reasonable

D The depreciation charge for motor vehicles is unlikely to be material therefore the rate used does not matter

4 **The audit plan includes a procedure to trace a sample of assets included in the non-current asset register to the physical asset. Which assertion is being tested?**

A Existence

B Completeness

C Valuation

D Rights and obligations

5 **Which of the following procedures provides the most reliable evidence when confirming rights and obligations for a non-current asset?**

A Physical inspection of the assets

B Inspection of the fixtures and fittings invoice

C Inspection of a valuation report for land and buildings

D Written representation from management confirming ownership

Test your understanding 11

You are assigned to the audit team of Carnarvon Co performing testing over non-current assets.

1 **Which of the following is NOT an audit procedure from ISA 500 *Audit Evidence*?**

A Inspection

B Enquiry

C Check

D Recalculate

2 **Which of the following audit procedures would confirm the existence of property, plant and equipment?**

A Recalculate the depreciation charge using the company's accounting policy

B Physically inspect a sample of assets listed in the non-current asset register

C Reconcile the schedule of property, plant and equipment with the general ledger

D Review the repairs and maintenance expense account in the statement of profit or loss for items which should be capitalised

3 **Which of the following is NOT a financial statement assertion relevant to your testing of non-current assets?**

A Occurrence

B Completeness

C Rights and obligations

D Existence

4 **Which of the following issues would result in a misstatement in the non-current assets balance?**

(i) An error in recording the cost of the asset.

(ii) A misclassification between fixtures & fittings and motor vehicles.

(iii) The depreciation charge has been correctly credited to accumulated depreciation but debited to the irrecoverable debt expense account.

(iv) A purchase invoice not being recorded in the asset register.

A (ii) and (iv)

B (i) and (iii)

C (ii) and (iii)

D (i) and (iv)

5 **When testing the assertion of rights and obligations over land and buildings, which of the following would provide the most reliable evidence?**

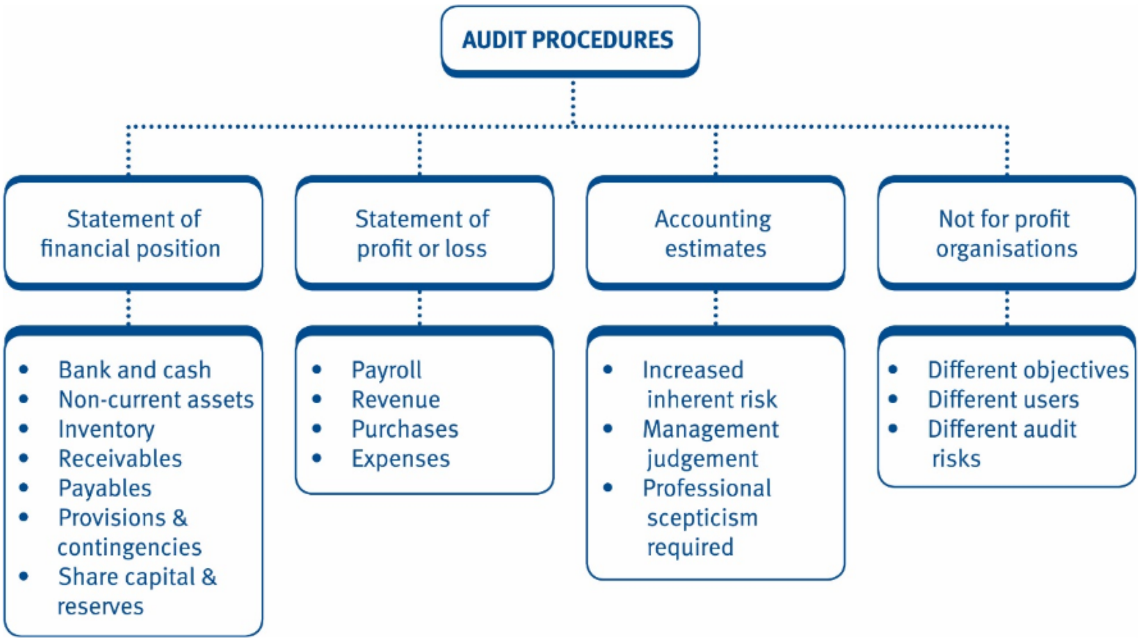
A Inspection of the insurance policy

B Physical inspection of the land and buildings

C Inspection of the title deeds

D Inspection of the non-current asset register

14 Chapter summary



Test your understanding answers

Test your understanding 1 – Bank and cash

- Obtain the bank reconciliation and cast to ensure arithmetical accuracy.
- Obtain a bank confirmation letter from Murray's bankers to confirm **existence and rights & obligations**.
- Agree the balance per the bank ledger account on the reconciliation to the year-end bank ledger account and financial statements to confirm **accuracy & valuation**.
- Agree the balance per the bank statement to an original year-end bank statement and also to the bank confirmation letter to confirm **accuracy & valuation**.
- Trace all of the outstanding lodgements to the pre-year-end bank ledger account, post-year-end bank statement and to the paying-in-book pre year end to confirm **accuracy & valuation and existence**.
- Trace all unpresented cheques through to a pre-year-end bank ledger account and post-year-end statement. For any unusual amounts or significant delays obtain explanations from management to confirm **accuracy & valuation and completeness**.
- Examine any old unpresented cheques to assess if they need to be written back into the trade payables account to confirm **accuracy & valuation and completeness**.
- Inspect the bank confirmation letter for details of any security provided by the company or any legal right of set-off as this may require disclosure to confirm appropriate **presentation**.
- Review the bank ledger account and bank statements for any unusual items or large transfers around the year end, as this could be evidence of window dressing. This verifies **completeness, existence**.
- Count the petty cash in the cash box at the year end and agree the total to the balance included in the financial statements to confirm **accuracy & valuation, and existence**.

Test your understanding 2 – Non-current assets

- Obtain the non-current asset register, cast and agree the totals to the financial statements: **completeness, classification, presentation**.
- Select a sample of assets from the non-current asset register and physically inspect them: **existence**.
- Select a sample of assets visible at the Murray's premises and inspect the asset register to ensure they are included: **completeness**.
- Inspect assets for condition and usage to identify signs of impairment: **valuation**.
- For revalued assets, inspect the independent valuation report and agree the amount stated to the amount included in the general ledger and the financial statements: **valuation**; and ensure that all assets in the same class have been revalued.
- Obtain a list of additions and for a sample, agree the cost to supplier invoice: **valuation**.
- Select a sample from the list of additions and review the description on the invoice to confirm that they relate to asset expenditure items rather than repairs and maintenance: **existence**.
- Inspect a breakdown of repairs and maintenance expenditure for the year to identify items which should be capitalised: **completeness**.
- For a sample of assets included in the non-current asset register, inspect supplier invoices (for equipment), title deeds (for property), and registration documents (for motor vehicles) to ensure they are in the name of the client: **rights and obligations**.

Disposals

- Obtain a breakdown of disposals, cast the list and agree all assets have been removed from the non-current asset register: **existence**.
- Select a sample of disposals and agree sale proceeds to supporting documentation such as sundry sales invoices: **accuracy of profit on disposal**.
- Recalculate the profit/loss on disposal and agree to the statement of profit or loss: **accuracy of profit on disposal**.

Depreciation

- Inspect the asset expenditure budgets for the next few years to assess the appropriateness of the useful economic lives in light of plans to replace assets: **valuation**.
- Review profits and losses on disposal of assets disposed of in the year to assess the reasonableness of the depreciation policies (if depreciation policies are reasonable, there should not be a significant profit or loss): **valuation**.
- Compare depreciation rates to companies with the same type of assets to assess reasonableness: **valuation**.
- Recalculate the depreciation charge for a sample of assets to verify arithmetical accuracy: **accuracy, valuation**.
- Recalculate the depreciation charge for revalued assets to ensure the charge is based on the new carrying amount: **accuracy, valuation**.
- Perform a proof in total calculation for the depreciation charged for each category of assets, discuss with management if significant fluctuations arise: **completeness, valuation**. **(Analytical procedure)**
- Review the financial statement disclosure of the depreciation charges and policies in the draft financial statements and compare to the prior year to ensure consistency: **presentation**.

Test your understanding 3 – Inventory

(a) **Before the inventory count**

– Contact the client to obtain a copy of the inventory count instructions to understand how the count will be conducted and assess the effectiveness of the count process.

– Review working papers obtained from the previous auditor (in subsequent years inspect prior year working papers) to understand the inventory count process and identify any issues that should be taken into account this year.

– Contact the client to obtain details of date, time and locations of the inventory count(s).

– Obtain a list of locations where inventory is stored and select which locations will be attended by the audit firm if not all locations can be visited. Priority should be given to locations with a high value of inventory or locations with poor controls.

- Consider the need for using an expert to assist in valuing the inventory being counted.
- Ascertain whether any inventory is held by third parties, and if possible, make arrangements to visit the third-party site.
- Request a direct confirmation of inventory balances held at the year end from any third-party warehouse providers regarding quantities and condition of inventory owned by the client.

(b) **During the count**

Tests of controls

- Observe the count to ensure that the inventory count instructions are being followed. For example:
  - No movements of inventory occur during the count.
  - Teams of two people perform the count.
  - Sections of inventory are tagged as counted to prevent double counting.
  - Damaged/obsolete items have been separately identified so they can be valued appropriately.
- Inspect the count sheets to ensure they have been completed in pen rather than pencil.
- Inspect the count sheets to ensure they show the description of the goods but do not show the quantities expected to be counted.
- Re-perform the sequence check on the count sheets to ensure none are missing.
- Enquire of the counting staff which department they work in to ensure they are not warehouse staff.

Substantive procedures

- Select a sample of items from the inventory count sheets and physically inspect the items in the warehouse: **existence**.
- Select a sample of physical items from the warehouse and trace to the inventory count sheets to ensure that they are recorded accurately: **completeness**.
- Enquire of management whether goods held on behalf of third parties are segregated and recorded separately: **rights and obligations**.
- Inspect the inventory being counted for evidence of damage or obsolescence that may affect the net realisable value: **valuation**.

- Record details of the last deliveries prior to the year end. This information will be used in the final audit to ensure that no further amendments have been made: **completeness & existence**.
- Obtain copies of the inventory count sheets at the end of the inventory count, ready for checking against the final inventory listing at the final audit: **completeness** and **existence**.
- Attend the inventory count at the third-party warehouses: **completeness and existence**.

(c) **At the final audit**

- Trace the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year end and to ensure that any errors identified during counting procedures have been rectified: **completeness, presentation**.
- Cast the list (showing inventory categorised between finished goods, WIP and raw materials) to ensure arithmetical accuracy and agree totals to financial statement disclosures: **completeness, classification**.
- Trace goods received immediately prior to the year end to year-end payables and inventory balances: **completeness & existence**.
- Trace goods despatched immediately prior to year end to the general ledger to ensure the items are not included in inventory and revenue (and receivables where relevant): **completeness & existence**.
- Inspect purchase invoices for the name of the client: **rights and obligations**.
- Inspect purchase invoices for a sample of inventory items to agree the cost of the items: **valuation**.
- Inspect post-year-end sales invoices for a sample of inventory items to determine if the net realisable value is reasonable. This will also assist in determining if inventory is held at the lower of cost and net realisable value: **valuation**.
- Recalculate work-in-progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption: **valuation**.
- Inspect the ageing of inventory items to identify old/slow-moving amounts that may require an allowance, and discuss these with management: **valuation**.

– Calculate the inventory holding period and compare this to prior year to identify slow-moving inventory which requires an allowance to bring the value down to the lower of cost and NRV: **valuation**. **(Analytical procedure)**

– Calculate the gross profit margin and compare this to prior year, investigate any significant differences that may highlight an error in cost of sales and closing inventory: **valuation**. **(Analytical procedure)**

Test your understanding 4 – Receivables

(a) **Jockeys:** the outstanding balance is over 20% of the total receivables balance at the year end and is therefore material.

Golf is Us: this large and old balance may require write-off or a specific allowance to be made if the recoverability of the amount is in doubt (similarly for Escot supermarket).

Tike & Co: the large and old credit balance on the listing suggests that an error may have been made. A payment from another customer may have been misallocated to this account or the customer may have overpaid an invoice, or paid an invoice twice in error. It may be appropriate to reclassify this balance, along with the balance for Whistlers, as a trade payable.

Whistlers: although the amount is small, the credit balance appears to be due to a difference between a recent large payment and the outstanding balance. This error may indicate other potential errors, and requires further investigation.

There are other balances that could be identified and justified for similar reasons to the above.

(b) **Receivables procedures**

– Obtain the list of individual customers, cast it and agree the total to the financial statements: **accuracy and presentation**.

– Agree the trade receivables account with the list of individual customer balances: **completeness** and **existence**.

– Select a sample of year-end receivable balances and agree back to valid supporting documentation of GDN and sales order: **existence**.

– Inspect after-date cash receipts and follow through to pre-year-end receivable balances: **valuation, rights and obligations** and **existence**.

- Select a sample of goods despatch notes (GDN) before and just after the year end and follow through to the sales invoice to ensure they are recorded in the correct accounting period: **completeness** and **existence** (**cut-off** of revenue).
- Perform a positive receivables circularisation of a representative sample of Murray Co's year-end balances, for any non-replies, with Murray Co's permission, send a reminder letter to follow-up: **existence** and **rights and obligations**.
- Inspect the aged receivables analysis to identify any slow-moving balances (such as Bibs and Balls, Golf is Us, James Smit Partnership) and discuss these with the credit control manager to assess whether an allowance or write-down is necessary: **valuation** and **allocation**.
- Discuss any significant balances with management (such as Escot, Jockeys, Golf is Us, James Smit Partnership, Stayrose Supermarket) to identify any issues regarding payment: **valuation**.
- Inspect customer correspondence in respect of any slow-moving/aged balances to assess whether there are any invoices in dispute: **valuation**.
- Inspect board minutes of Murray Co to assess whether there are any material disputed receivables that may require write-off: **valuation**.
- Inspect the list of individual customer balances for any credit balances (such as Whistler and Tike) and discuss with management whether these should be reclassified as payables: **existence of receivables** and **completeness of payables, classification**.
- Inspect a sample of post-year-end credit notes to identify any that relate to pre-year-end transactions to ensure that they have not been included in receivables: **existence** (**occurrence** of revenue).
- Calculate the average receivables collection period and compare this to prior year, investigate any significant differences: **completeness** and **valuation**. **(Analytical procedure)**

Test your understanding 5 – Payables

Many companies send out monthly statements of account as part of their credit control procedures. It is likely that audit clients will receive a number of these statements from suppliers at the year end. These can be reconciled to the trade payables account to ensure the accounting records are correct. This is known as a supplier statement reconciliation and is an important source of audit evidence.

There are two main reasons why there may be a variance:

- **Timing differences,** e.g. invoices sent by the supplier but not yet received by the customer; payments sent by the customer but not yet received by the supplier; returns and credit notes not yet appearing on the supplier's statement; or
- **Errors.**

(a) **Reconciliation of individual supplier balance to the balance on supplier's statement:**

		$	$
	Balance per individual supplier's account:		**59,800**
	Differences:		
(i)	31.11: Discount not allowed by supplier	1,260	
(ii)	04.11: Transposition error, invoice 6080	1,800	
(iii)	04.12: Invoice 6210 not on individual supplier account	47,350	
(iv)	28.12: Invoice 6355 not on individual supplier account	62,980	
(v)	31.12: Cash in transit	60,050	
(vi)	Discount not allowed	1,230	
			174,670
	Balance per supplier's statement:		**234,470**

(b) **Audit work**

(i) The date of the payment for the October invoices suggests that Racket Co will not have received the payment for $61,630 until after the 30 November and so Murray Co may not be entitled to the 2% cash discount. The entry in Murray Co's records suggests the payment was sent on 30 November however this is not conclusive evidence.

– The auditor should enquire with Murray Co's payables ledger clerk about this item, and inspect correspondence with Racket Co to establish entitlement to the discount.

– If Murray Co is obliged to pay the 2% disallowed discount, this should be added to Racket Co’s individual supplier account.

– If Racket Co will allow the discount, there is no need to make any adjustments to Racket Co’s individual supplier account.

(ii) The apparent transposition error on invoice 6080 should be checked by inspecting the invoice.

– If the invoice shows $37,520, then an additional payable of $1,800 should be included at the year end to correct this error.

– No adjustment will be necessary if Murray Co's figure is correct.

(iii) It appears that invoice 6210 for $47,350 has not been included in Murray Co's records.

– The auditor should enquire with the warehouse manager whether these goods have been received.

– The GRNs around the expected delivery date should be inspected to identify the relevant GRN.

– Correspondence with Racket Co should be reviewed for discussions relating to a dispute regarding these goods (if relevant).

– If the goods have been received, the purchase invoices file should be inspected to identify if there is a related purchase invoice.

– If there is a purchase invoice, the auditor should enquire with the purchases department why the invoice has not been posted to Racket Co’s account. This may be because of a dispute (e.g. an incorrect price, the wrong quantity or a fault with the goods).

- If the goods relating to this invoice are in inventory (or have been sold) a purchase accrual should be made for this item (note that the actual quantity of goods received should be accrued for) and correspondence relating to this invoice with Racket Co should be inspected to assess what payment has been agreed.
- If the goods have not been received, no adjustment needs to be made (but a copy of correspondence disputing the delivery/invoice should be placed on file as evidence).

(iv) The appropriate treatment of invoice 6355 depends on whether or not Murray Co received the goods before the year end.

- The auditor should inspect the GRN for the date to determine if the goods were received before the year end.
- If the date is before the year end, Murray Co should be asked to include a purchase accrual at the year end for this invoice.

(v) The cheque on 31 December appears to be cash in transit.

- The auditor should inspect Murray Co's bank statement to confirm that the cheque was cleared by the bank after the year end.
- If the cheque cleared within one week of the year end (with most other cheques issued immediately before the year end) then this is valid cash in transit.
- If most cheques issued immediately before the year end take more than a week to clear, this indicates window-dressing of the financial statements (i.e. the cheques were actually sent out after the year end), in which case the amounts should be credited back to trade payables and debited back to cash.

(iv) If, as appears likely, the cheque for $60,050 is not received by Racket Co until sometime after the year end, then the discount of $1,230 may be disallowed. If this discount is disallowed, it should be added to payables at the year end (see (i) above).

Test your understanding 6

(a) **Assertions: classes of transactions**

- **Occurrence**: The transactions and events that have been recorded and disclosed have actually occurred and pertain to the entity.
- **Completeness**: All transactions and events that should have been recorded have been recorded.
- **Accuracy**: The amounts and other data relating to recorded transactions and events have been recorded appropriately.
- **Cut-off**: Transactions and events have been recorded in the correct accounting period.
- **Classification**: Transactions and events have been recorded in the proper accounts.
- **Presentation**: Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the applicable financial reporting framework.

Note: Only four assertions required.

(b) **Tangible non-current assets: assertions and procedures**

- **Completeness:** Agree a sample of assets physically verified on the premises back to the asset register to ensure that all non-current assets are recorded.
- **Existence:** Physically inspect a sample of assets included in the non-current asset register to verify existence.
- **Accuracy, valuation and allocation:** Recalculate the depreciation charge to ensure arithmetical accuracy.
- **Rights and obligations**: Inspect an appropriate document of ownership for example, a purchase invoice, for the client's name to confirm the entity owns or controls the asset.
- **Classification/Presentation:** Review the non-current asset disclosure note in the financial statements and agree the figures to the non-current asset register to ensure assets are properly disclosed under the correct headings as required by IAS 16 *Property, Plant and Equipment.*

Test your understanding 7

(a) **Before the count**

- Inspect prior year working papers to understand the inventory count process and identify any issues that should be taken into account this year.
- Contact Numero Uno (client) to obtain inventory count instructions for this year to understand how the count will be conducted and assess the effectiveness of the count process.
- Ascertain whether any inventory is held by third parties. Determine how to gather sufficient appropriate evidence e.g. by visiting the premises or requesting an external confirmation.
- Consider the need for using an expert to assist in valuing the inventory being counted. There may be some specialty wines and spirits that require expert valuation.

During the count

- Observe the count to ensure that the instructions are being followed.
- Inspect the bottles being counted for evidence of damage or obsolescence that may affect the net realisable value and hence overall valuation of inventory.
- Select a sample of beverages from the inventory count sheets and physically inspect the items in the cellar or bar to confirm they exist.
- Select a sample of physical beverages from the cellar or bar and trace to the inventory count sheets to ensure that they are recorded accurately and therefore that the records are complete.
- Record cut-off information by obtaining details of the last deliveries prior to the year end. This information will be used in the final audit to ensure that no further amendments have been made which could result in overstatement or understatement of inventory.

(b) **Inventory assertions**

Identify	**Explain**
Existence	The inventory recorded actually exists.
Rights and obligations	The company owns or controls the asset and therefore has the right to record the inventories in its financial statements.
Completeness	All inventory balances have been recorded.
Accuracy, valuation and allocation	Inventories are valued appropriately (i.e. at lower of cost and net realisable value).
Cut-off	Inventory movements around the year end are recorded in the correct period.
Presentation	Inventory is disclosed properly in the financial statements as raw materials, work-in-progress and finished goods.

(c) **Substantive procedures**

– Trace the items counted during the inventory count to the final inventory listing to ensure the quantities are the same and any errors identified during counting procedures have been rectified.

– Inspect purchase invoices for a sample of beverages to agree cost, ensuring that the description of goods on the invoice matches the beverage.

– For beverages sold to customers after the year end, inspect a sample of restaurant bills/invoices back to the final inventory records ensuring that the sales value exceeds the cost. Where sales value is less than cost, ensure that the beverage is stated at the realisable value.

– For high value items such as champagne, vintage wine and exotic spirits, use an expert valuer to review the net realisable value of a sample of items to ensure the value is reasonable.

– For inventory noted during the count as obsolete or damaged, trace to the inventory records to ensure the valuation has been adjusted to take this into account. The expert valuer may provide assistance with these valuations.

Test your understanding 8

(a) **Trade receivables circularisation**

- Obtain client approval to perform a direct confirmation of trade receivables.
- Obtain the list of receivables balances, and cast it.
- Select a suitable sample from the list of receivables balances using an appropriate sampling technique.
- Prepare the confirmation letters ensuring the contact details are correct and return details clearly state that the reply should be made direct to the auditor. A business reply envelope, addressed to the auditor, could be included for this purpose.
- Ask the client to print the letters on client-headed paper and sign them. The letters should then be returned to the auditor.
- The auditor should send the letters, including any follow-up requests. This process should be controlled by the auditor to ensure the integrity of the test.
- Reconcile replies received to the audit client's receivables accounting records.
- Perform alternative audit procedures on balances where no response to the confirmation letter is received.

(b) **Sufficiency of the evidence from a direct confirmation test**

- There is often a low response rate from trade receivables meaning that other audit procedures will be required for these balances.
- The type of confirmation letter, whether a positive or negative confirmation request, will influence the sufficiency of evidence gathered. Negative confirmations provide less persuasive audit evidence than positive confirmations and it is unlikely that a negative confirmation will provide sufficient evidence on its own.
- The reliability of the responses to the confirmation requests may be in doubt, for example if there is a risk of fraud being perpetrated.
- Mistakes and errors may be present in the accounting records of the trade receivables confirming the balance outstanding.
- Customers may agree with balances containing errors in their favour.

(c) **Substantive procedures for trade receivables**

– Obtain the receivables listing, cast it to verify arithmetical accuracy and agree the total to the financial statements.

– Confirm the trade receivables account balance matches the sum of the list of individual customers to confirm completeness.

– For a sample GDNs around the year end, trace to the sales invoice and individual customer accounts to ensure that the transactions have been recorded in the correct accounting period.

– Select a sample of individual trade receivables and perform a direct confirmation test using a positive confirmation letter.

– Inspect the bank ledger account and bank statements for cash received post year end.

– Recalculate the general allowance based on the 2% figure to ensure arithmetical accuracy.

– Discuss with management why the general allowance has reduced from 3% to 2% and assess the reasonableness of the explanations provided and the reason for not making specific allowances for the two customers in administration who owe material amounts at the year end.

– Inspect the aged receivables analysis to identify aged debts that may require a specific allowance. Discuss with management any such balances and ensure specific allowances are made if appropriate.

– Confirm that the specific allowances made in the prior year were either written-off or the cash was recovered in the current accounting period.

(d) **Audit software**

– Audit software can be used to prepare an aged receivables analysis and to identify potential irrecoverable debts using a range of criteria set by the auditor.

– Audit software can be used to quickly identify credit balances or negative balances within the list of individual customers.

– Audit software will be more efficient and accurate at casting the list of individual customers and recalculating figures such as the general allowance.

– It could also select a sample for testing and prepare direct confirmation letters.

Test your understanding 9

1	C	Substantive procedures must be performed on all material balances, even if controls are working effectively. This is due to the inherent limitations of controls. However, the level may be reduced if controls are found to be effective.
2	C	Selecting transactions around the year end tests the assertion of cut-off.
3	B	If the receivable was overstated the related sale would also be overstated. To test for overstatement the auditor must choose a sample from within the accounting system and trace it back to supporting documentation.
4	A	B, C and D are all substantive tests of detail as they focus attention on individual sales transactions. Comparison of sales in the current year to the prior year is an analytical procedure as it is focused on identifying unusual trends or fluctuations which may indicate misstatement.
5	D	Occurrence. The transaction will not have occurred if it is fictitious. Existence is not relevant to the statement of profit or loss.

Test your understanding 10

1	D	Depreciation affects the valuation assertion therefore options A and B are incorrect. If depreciation has not been charged, the assets will be overvalued therefore option C is incorrect.
2	C	Enquiry on its own is not the most reliable form of evidence and should be corroborated with other procedures. The auditor would not contact the supplier and this would not provide evidence of the useful life of the fixtures to Leveque Co. Comparison with other clients is only useful if those clients are in the same type of industry and using the same type of assets in the same manner as Leveque Co.
3	A	The depreciation rate should match the usage of the asset by the company, therefore the rate should be based on 3 years not 5 years. As no figures are given for the motor vehicles it cannot be said that depreciation will be immaterial.
4	A	Testing from the accounting records (asset register) to the source addresses the assertion of existence.
5	B	Physical inspection verifies existence. A valuation certificate verifies the valuation of the land and buildings. Neither of these procedures confirms the assets are owned or controlled by Leveque Co. Written confirmation is not a reliable form of evidence for the assertion of rights and obligations as better procedures can be performed. The purchase invoice for fixtures and fittings should contain the name of the client which would help verify rights and obligations.

Test your understanding 11

1	C	Check is not a valid procedure. Every procedure 'checks' something. The auditor can check through inspection, enquiry, observation, etc.
2	B	Option A tests the accuracy of a depreciation charge. Options C and D test the completeness of PPE. Option B confirms existence.
3	A	Occurrence is an assertion relevant to the statement of profit or loss, not the statement of financial position.
4	D	A misclassification between motor vehicles and fixtures & fittings will not affect the overall non-current assets balance. The depreciation charge has been correctly credited to accumulated depreciation therefore the asset's carrying amount will be correctly calculated. The mis-posting to irrecoverable debt expense will mean the classification of the expense in the statement of profit or loss is incorrect. An error recording the cost of the asset will mean the asset is misstated. If the purchase invoice relating to the asset is not recorded, assets will be understated.
5	C	The other procedures do not confirm the client owns or controls the assets. The title deeds in the client's name will confirm ownership.

Chapter

11

Completion and review

Chapter learning objectives

This chapter covers syllabus areas:

- E1 – Subsequent events
- E2 – Going concern
- E3 – Written representations
- E4 – Audit finalisation and the final review

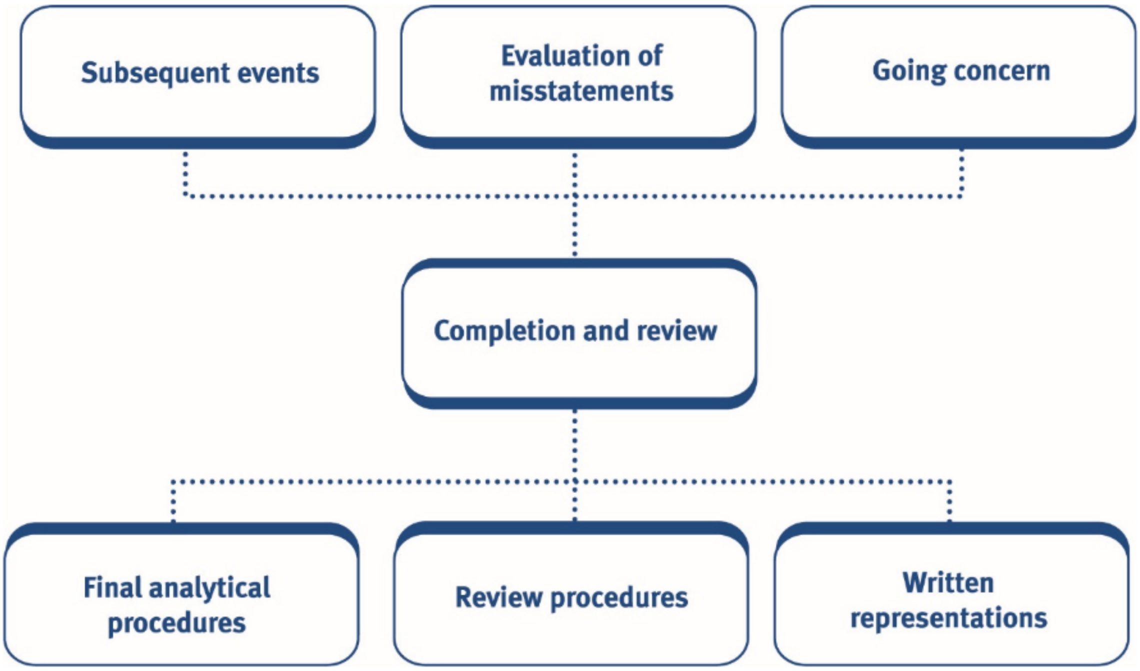
Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO20) is to review and report on the findings of an audit. You complete an audit, preparing the formal documentation and reporting any control deficiencies to management. You report back to managers in a formal audit report. Working through this chapter should help you understand how to demonstrate that objective.

1 Introduction

After the auditor has completed the substantive testing there are still many procedures that need to be performed before they can sign the auditor's report. These include:



2 Subsequent events

A subsequent event is: **An event occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report**. [ISA 560 *Subsequent Events*, 5e].

ISA 560 *Subsequent Events,* para 4, requires the auditor to:

- Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report, that require adjustment or disclosure are appropriately reflected in accordance with the applicable financial reporting framework.
- Respond appropriately to facts that become known to the auditor after the date of the auditor's report.

IAS 10 *Events After the Reporting Period* identifies two types of event after the reporting period:

- Adjusting
- Non-adjusting.

Illustration 1 – Adjusting and non-adjusting events

Adjusting events

These are events that provide additional evidence relating to conditions existing at the reporting date. Such events provide new information about the items included in the financial statements and hence the financial statements should be adjusted to reflect the new information.

Examples of **adjusting** events include:

- Allowances for damaged inventory and doubtful receivables.
- Amounts received or receivable in respect of insurance claims which were being negotiated at the reporting date.
- The determination of the purchase or sale price of non-current assets purchased or sold before the year end.
- Agreement of a tax liability.
- Discovery of errors/fraud revealing that the financial statements are incorrect.

Non-adjusting events

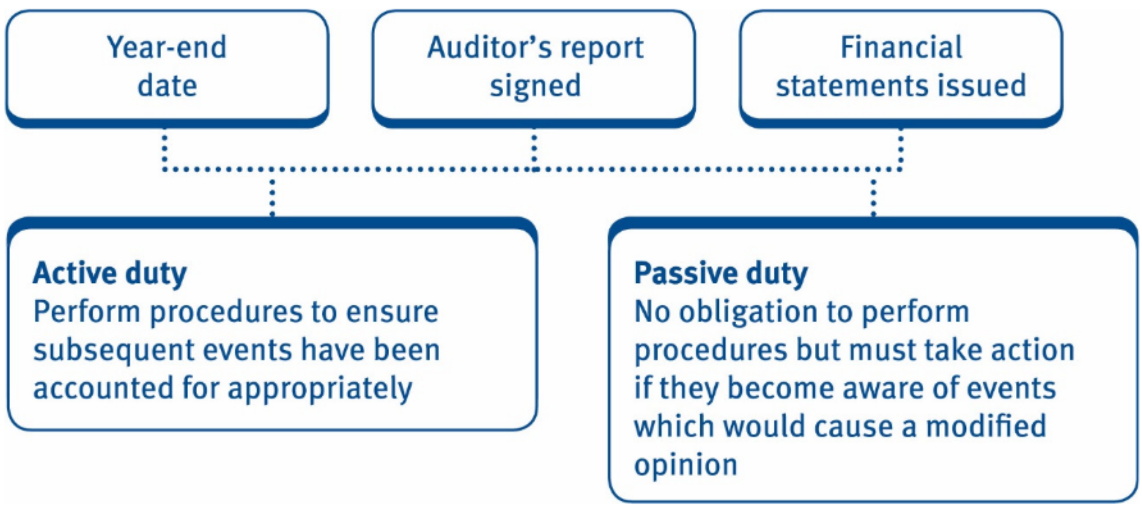
These are events concerning conditions which arose after the reporting date. If material, disclosure is required in the notes to the financial statements indicating what effect the events may have. Such events, therefore, will not have any effect on items in the statements of financial position or statement of profit or loss for the period.

Examples of **non-adjusting** events include:

- Issue of new share or loan capital.
- Major changes in the composition of the group (for example, mergers, acquisitions or reconstructions).
- Losses of non-current assets or inventory as a result of fires or floods.
- Strikes, government action such as nationalisation.
- Purchases/sales of significant non-current assets.

(IAS 10 *Events After the Reporting Period*)

Auditor responsibilities



Between the date of the financial statements and the date of the auditor's report

- The auditor should perform procedures to identify events that might require adjustment or disclosure in the financial statements. [ISA 560, 6]
- If material adjusting events are not adjusted for, or material non-adjusting events are not disclosed, the auditor will ask management to make the necessary amendments to the financial statements.
- If the identified adjustments or disclosures necessary are not made, the auditor should consider the impact on the auditor's report and whether a modification to the opinion is necessary.

Subsequent events procedures

- Enquiring of management if they are aware of any events, adjusting or non-adjusting, that have not yet been included or disclosed in the financial statements.
- Enquiring into management procedures/systems for the identification of events after the reporting period.
- Reading minutes of members' and directors' meetings.
- Reviewing accounting records including budgets, forecasts, cash flows, management accounts and interim information. [ISA 560, 7]
- Obtaining a written representation from management confirming that they have informed the auditor of all subsequent events and accounted for them appropriately in the financial statements. [ISA 560, 9]
- Inspection of correspondence with legal advisors. [ISA 560, A8]
- Reviewing the progress of known risk areas and contingencies. [ISA 560, A9]

- Considering relevant information which has come to the auditor's attention, from sources outside the entity, including public knowledge, competitors, suppliers and customers.
- Inspecting after-date receipts from receivables.
- Inspecting the cash ledger account after the year end for payments/receipts that were not accrued for at the year end.
- Inspecting the sales price of inventories after the year end.

Between the date of the auditor's report and the date the financial statements are issued

- The auditor is under no obligation to perform audit procedures after the auditor's report has been issued, however, if they become aware of a fact which would cause them to amend the auditor's report, they must take action. [ISA 560, 10]
- This will normally be in the form of asking the client to amend the financial statements, auditing the amendments and reissuing the auditor's report.
- If management does not amend the financial statements and the auditor's report has not yet been issued to the client, the auditor can still modify the opinion. [ISA 560, 13a]
- If the auditor's report has been provided to the client, the auditor shall notify management and those charged with governance not to issue the financial statements before the amendments are made.

  If the client issues the financial statements despite being requested not to by the auditor, the auditor shall take action to prevent reliance on the auditor's report. [ISA 560, 13b]

  Legal advice should be sought in this situation as the course of action to prevent reliance on the auditor's report depends on the auditor's legal rights and obligations. [ISA 560, A16]

After the financial statements are issued

- The auditor is under no obligation to perform audit procedures after the financial statements have been issued, however, if they become aware of a fact which would have caused them to amend the auditor's report, they must take action.
- The auditor should discuss the matter with management and consider if the financial statements require amendment. [ISA 560, 14]
- The auditor should perform audit procedures on the amendments to ensure they have been put through correctly. [ISA 560, 15a]
- The auditor should review the steps taken by management to ensure anyone who is in receipt of the previously issued financial statements is informed. [ISA 560, 15b]

- Issue a new auditor's report including an emphasis of matter or other matter paragraph to draw attention to the fact that the financial statements and auditor's report have been reissued. [ISA 560, 16]
- If management refuses to recall and amend the financial statements, the auditor shall take action to prevent reliance on the auditor's report. [ISA 560, 17]

Test your understanding 1

Murray case study: Subsequent events review for the year ended 31 December 20X4

1 On 2 January 20X5, Golf is Us, a major customer of Murray Co, was placed into administration owing $211,000.

2 On 3 January 20X5, the sales director left the company. The sales director is suing Murray Co for constructive dismissal. If successful, the claim amounts to $280,000.

3 On 5 February 20X5 there was a fire at the premises of the third party warehouse provider, which destroyed all inventory held there. Approximately one half of Murray Co's inventory was stored in these premises. The total value of inventory stored at the premises was $1,054,000.

4 The financial statements include a $40,000 provision for an unfair dismissal case brought by an ex-employee of Murray Co. On 7 February 20X5 a letter was received from the claimant's solicitors stating that they would be willing to settle out-of-court for $25,000. It is likely the company will agree to this.

Financial statement extracts	**31 Dec 20X4**	**31 Dec 20X3**
	$000	$000
Revenue	21,960	19,580
Total assets	9,697	7,288
Profit before tax	1,048	248

Required:

For each of the events above discuss whether the financial statements require amendment in order to avoid a modified audit opinion.

3 Going concern

The going concern concept

Going concern is the assumption that the entity will continue in business for the foreseeable future.

- The period that management (and therefore the auditor) is required to consider is the period required by the applicable financial reporting framework or by law or regulation if longer.

  Generally, the period is a minimum of twelve months from the year end. In some jurisdictions the period is a minimum of twelve months from the date the financial statements are approved (e.g. the UK).
  [ISA 570, 13]

- Consideration of the foreseeable future involves making a judgement about future events, which are inherently uncertain.

  Uncertainty increases with time and judgements can only be made on the basis of information available at any point. Subsequent events can overturn that judgement.
  [ISA 570, 5]

The going concern concept – significance

Whether or not a company can be classed as a going concern affects how its financial statements are prepared.

Financial statements are prepared using the going concern basis of accounting, unless:

- management either intends to liquidate the entity or to cease trading, or
- has no realistic alternative but to do so.

  (ISA 570, 2)

Where the assumption is made that the company will cease trading, the financial statements are prepared using the **break-up or liquidation basis** under which:

- The basis of preparation and the reason why the entity is not regarded as a going concern are disclosed.
- Assets are recorded at likely sale values.
- Inventory and receivables may need to be written down as inventory may be sold for a lower price or may be scrapped, and receivables may not pay if they know the company is ceasing to trade.
- Additional liabilities may arise (redundancy costs for staff, the costs of closing down facilities, etc.).

Responsibilities for going concern

Directors

- It is the directors' responsibility to assess the company's ability to continue as a going concern when they are preparing the financial statements. [ISA 570, 4]
- In order to do this the directors should prepare forecasts to help assess whether they are likely to be able to continue trading for the next 12 months as a minimum.
- When the directors are performing their going concern assessment they should take into account a number of relevant factors such as:
  - Current and expected profitability
  - Debt repayment
  - Sources (and potential sources) of financing.

Going concern disclosures required by the directors in the financial statements

1. Where there is any **material uncertainty over the future of a company**, the directors must include disclosure in the financial statements.
   A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that disclosure of the nature and implications of the uncertainty is necessary for the fair presentation of the financial statements and for the financial statements not to be misleading. [ISA 570, 18]

   The disclosure should explain:

   - the principal events or conditions that cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with them
   - that the company may be unable to realise its assets and discharge its liabilities in the normal course of business.

   [ISA 570, 19]

2. Where the directors have been **unable to assess going concern in the usual way** (e.g. for less than one year beyond the date on which they sign the financial statements), this fact should be disclosed.
3. Where the **financial statements are prepared on a basis other than the going concern basis**, the basis used should be disclosed.

Auditors

ISA 570 *Going Concern*, para 9, states that the auditor shall:

- Obtain sufficient appropriate evidence regarding the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.
- Conclude on whether a material uncertainty exists about the entity's ability to continue as a going concern.
- Report in accordance with ISA 570.

Indicators of going concern problems

Typical indicators and explanations of going concern problems include the following:

- Net current liabilities (or net liabilities overall): indicates an inability to meet debts as they fall due.
- Borrowing facilities not agreed or close to expiry of current agreement: lack of access to cash may make it difficult for a company to manage its operating cycle.
- Defaulted loan agreements: loans normally become repayable on default, the company may find it difficult to repay loan.
- Unplanned sales of non-current assets: indicates an inability to generate cash from other means and as non-current assets generate income, sale of assets will cause a decline in income and therefore profit.
- Missing tax payments: results in fines and penalties, companies normally prioritise tax payments indicating a lack of working capital.
- Failure to pay the staff: indicates a significant lack of working capital.
- Negative cash flow: indicates overtrading.
- Inability to obtain credit from suppliers: suggests failure to pay suppliers on time and working capital problems.
- Major technology changes: inability or insufficient funds to keep up with changes in technology will result in loss of custom and obsolescence of inventory.
- Legal claims: successful legal claims may result in significant cash payments that can only be settled with liquidation.
- Loss of key staff: may result in an inability to trade.
- Over-reliance on a small number of products, staff, suppliers or customers: loss may result in an inability to trade.
- Customers ceasing to trade or having cash flow difficulties: likely to become an irrecoverable debt and therefore payment won’t be received.

- Emergence of a successful competitor: will impact revenue if customers switch.
- Uninsured/under-insured catastrophes: the company may not have enough cash to survive.
- Changes in laws and regulations: the cost of compliance may be more than the company can afford.

  [ISA 570, A3]

Audit procedures

Audit procedures to assess management's evaluation of going concern

- Evaluate management's assessment of going concern. [ISA 570, 12]
- Assess the same period that management has used in its assessment and if this is less than 12 months, ask management to extend its assessment. [ISA 570, 13]
- Consider whether management's assessment includes all relevant information. [ISA 570, 14]

Audit procedures to perform where there is doubt over going concern

- Analyse and discuss cash flow, profit and other relevant forecasts with management. This should include assessment of the reasonableness of the assumptions used to prepare the forecasts.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of meetings for reference to financing difficulties.
- Enquire of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Review events after the year end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

  [ISA 570, A16]

- Review correspondence with customers for evidence of any disputes that might impact recoverability of debts and affect future sales.
- Review correspondence with suppliers for evidence of issues regarding payments that might impact the company's ability to obtain supplies or credit.

- Review correspondence with the bank for indication that a bank loan or overdraft may be recalled.
- Obtain written representation from management regarding its plans for the future and how it plans to address the going concern issues.
  [ISA 570, 16e]

Tutorial note

Audit procedures should focus on cash flows rather than profits. A company can continue to trade as long as it can pay its debts when they fall due. Therefore identify procedures to obtain evidence about the amount of cash that is likely to be received and the amount of cash that it likely to be paid out and consider whether there is any indication of cash flow difficulties.

Reporting implications

The auditor should modify the audit opinion if the directors have not made adequate disclosure of any material uncertainty related to going concern or if the directors have not prepared the financial statements on the appropriate basis.

The auditor should issue an unmodified opinion with additional communication if the directors have appropriately disclosed going concern uncertainties or prepared the financial statements on the break-up basis.

Reporting implications in relation to going concern are covered in more detail in the Reporting chapter.

Examination of a cash flow forecast

One way of assessing the client's ability to continue as a going concern is to examine the **reasonableness of the assumptions** used to prepare the cash flow forecast.

The following procedures are typical of those that would be performed in the examination of a cash flow forecast:

- Agree the opening balance of the cash forecast to the cash ledger account, to ensure accuracy.
- Consider how reasonable company forecasts have been in the past by comparing past forecasts with actual outcomes. If forecasts have been reasonable in the past, this would provide some confidence over the reasonableness of the current forecast.
- Determine the assumptions that have been made in the preparation of the cash flow forecast. For example, if the company is operating in a poor economic climate, you would not expect cash flows from sales and realisation of receivables to increase, but either to decrease or remain stable. If costs are rising you would expect payments to increase in the cash flow forecast.
- Agree the timing of receipts from realisation of receivables and payments to suppliers with credit periods and previous trade receivables and payables payment periods.
- Examine the company's detailed budgets for the forecast period and discuss any specific plans with the directors.
- Examine the assessment of the non-current assets required to meet production needs. Agree cash outflows for non-current assets to supplier quotations.
- For acquisitions of buildings, agree the timing and amount of cash outflows to the expected completion date and consideration in the draft sale and purchase agreement.
- Consider the adequacy of the increased working capital and the working capital cash flows included in the forecast.
- If relevant, compare actual performance in the most recent management accounts to the forecast figures.
- Recalculate the cash flow forecast balances to verify arithmetical accuracy.
- Inspect board minutes for any other relevant issues which should be included within the forecast.

Test your understanding 2

Murray case study: Going concern review for the year ended 31 December 20X4

On 2 January 20X5, Golf is Us, a major customer of Murray Co, was placed into administration owing $211,000.

On 3 January 20X5, the sales director left the company and has yet to be replaced. The sales director is suing Murray Co for constructive dismissal.

On 5 January 20X5 there was a fire at the premises of the third party warehouse provider, which destroyed all inventory held there. Approximately one half of Murray Co's inventory was stored in these premises.

The assembly line for ergometers (rowing machines) was refurbished during the year at a cost of $1 million. The additional $1.5 million loan facility provided to Murray Co during the year is secured, in part, on the refurbished assembly line. The assembly line broke down during January and six weeks later is still not working.

The company is seeking new funding through an initial public offering of shares in the company (i.e. listing on the stock exchange). In the event that the initial public offering does not proceed, this will require Murray Co's existing banking arrangements to be renegotiated and additional funding to be raised from either existing or new investors.

The financial statements of Murray Co show an overdraft at 31 December 20X4 of $180,000 (20X3: $120,000). The overdraft limit is $250,000. The cash flow forecast shows negative monthly cash flows for the next twelve months. As a result of cash shortages in February 20X5, a number of suppliers were paid late.

Required:

Using the information provided, explain the potential indicators that Murray Co is not a going concern.

4 Overall review of the financial statements

Before forming an opinion on the financial statements and deciding on the wording of the auditor's report, the auditor should conduct **an overall review**.

The auditor should perform the following procedures:

1 Review the financial statements to ensure:

   – compliance with accounting standards and local legislation disclosure requirements. This is sometimes performed using a disclosure checklist.

   – accounting policies are sufficiently disclosed and to ensure that they are in accordance with the accounting treatment adopted in the financial statements.

   – they adequately reflect the information and explanations previously obtained and conclusions reached during the course of the audit.

2 Perform analytical procedures to corroborate conclusions formed during the audit and assist when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. [ISA 520, 6]

3 Review the aggregate of the uncorrected misstatements to assess whether a material misstatement arises. If so, discuss the potential adjustment with management.

The purpose of review procedures

Review forms part of the engagement performance quality management procedures covered in the Planning chapter.

As part of the overall review, the auditor should assess whether:

- The audit work was performed in accordance with professional standards.
- Significant matters have been raised for further consideration and appropriate consultations have taken place.
- There is a need to revise the nature, timing and extent of the work performed.
- The audit evidence gathered by the team is sufficient and appropriate to support the conclusions reached and provides a basis for the audit opinion.

  [ISA 220 (Revised), A88]

The auditor should ensure that initial assessments made at the start of the audit are still valid in light of the information gathered during the audit and that the audit plan has been flexed to meet any new circumstances.

5 Evaluation of misstatements

The auditor must consider the effect of misstatements on both the audit procedures performed and ultimately, if uncorrected, on the financial statements as a whole. Guidance on how this is performed is given in ISA 450 *Evaluation of Misstatements Identified During the Audit.*

The auditor must:

- Accumulate a record of all identified misstatements, unless they are clearly trivial. [ISA 450, 5]
- Consider if the existence of such misstatements indicates that others may exist, which, when aggregated with other misstatements, could be considered material. [ISA 450, 6a]
- If so, consider if the audit strategy and plan need to be revised. [ISA 450, 6]
- Communicate all accumulated misstatements to an appropriate level of **management** on a timely basis and request that **all** misstatements are corrected. [ISA 450, 8]
- If management refuses to correct some or all of the misstatements the auditor should consider their reasons for refusal and take these into account when considering if the financial statements are free from material misstatement. [ISA 450, 9]

Evaluation of uncorrected misstatements

If management has failed to correct all of the misstatements, the auditor should:

- Reassess materiality to determine whether it is still appropriate in the circumstances as the level of risk may be deemed higher as a result of management's refusal. [ISA 450, 10]
- Determine whether the uncorrected misstatements, either individually or in aggregate, are material to the financial statements as a whole, considering both the size and nature of the misstatements and the effect of misstatements related to prior periods (e.g. on corresponding figures, comparatives and opening balances). If an individual misstatement is considered material it cannot be offset by other misstatements. [ISA 450, 11]
- Communicate the uncorrected misstatements to **those charged with governance** and explain the effect this will have on the audit opinion. [ISA 450, 12]
- Request a written representation from management and those charged with governance that they believe the effects of uncorrected misstatements are immaterial. [ISA 450, 14]

Evaluation of misstatements

You are at the completion stage of the audit of Murray Co. The profit before tax for the year is $1,048,000 and total assets are $9,697,000. The following matters have not been corrected by management and have been left for your attention:

1 An irrecoverable debt of $211,000 has not been written off.

2 An adjustment to a provision relating to the unfair dismissal of an ex-employee of $15,000 has not been made.

3 Website development costs of $50,000 were incorrectly capitalised.

4 Work in progress was overvalued by $45,000.

All of these misstatements must be communicated to management and requested to be adjusted in accordance with ISA 450.

The irrecoverable debt must be written off to avoid a modified opinion as it is individually material. A material misstatement cannot be off-set by other misstatements.

Even if management agrees to write-off the irrecoverable debt, the other uncorrected misstatements are material in aggregate even though they are not material individually.

The adjustments required are:

- Provision: DR Provision (SOFP), CR Provision expense (SOPL) – $15,000
- Website development costs: DR Expenses (SOPL), CR Website development costs (SOFP) – $50,000
- Work in progress: DR Closing inventory (SOPL), CR Inventory (SOFP) – $45,000.

The overall adjustment required to the SOPL is $80,000. This represents 7.6% of PBT and is material.

The misstatements will need to be adjusted to avoid a modified opinion.

6 Written representations

A written representation is: **A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence**. [ISA 580 *Written Representations*, 7].

Purpose of written representations

ISA 580 *Written Representations* requires the auditor to obtain written representations from management:

- That it has fulfilled its responsibility for the preparation of the financial statements. [ISA 580, 6a]
- To support other audit evidence relevant to the financial statements or specific assertions if deemed necessary by the auditor or required by specific ISAs. [ISA 580, 6b]
- That the auditor has been provided with all relevant information. [ISA 580, 11a]
- That all transactions have been recorded and reflected in the financial statements. [ISA 580, 11b]

A representation to support other audit evidence may be appropriate where more reliable forms of evidence are not available, particularly in relation to matters requiring management judgement or knowledge restricted to management. Examples include:

- Whether the selection and application of accounting policies are appropriate.
- Whether the following matters have been measured, presented and disclosed in accordance with the relevant financial reporting framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities.
  - Liabilities, both contingent and actual.
  - Title to, or control over, assets.
  - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

  [ISA 580, A10]
- That the directors have communicated all deficiencies in internal control to the auditor. [ISA 580, A11]
- Specific assertions about classes of transactions, accounts balances and disclosures requiring management judgement. [ISA 580, A13]

Note that written representations cannot be a substitute for more reliable evidence that should be available and do not constitute sufficient appropriate evidence on their own, about any of the matters with which they deal. [ISA 580, 4]

Written representations should only be sought to support other audit evidence.

Process for obtaining a written representation

In practice, the auditor will draft the wording of the written representation letter but it must be printed on client headed paper, addressed to the auditor and signed by the client.

The letter must be signed by an appropriate senior member of client management, with appropriate responsibilities for the financial statements and knowledge of the matters concerned. This would normally be the chief executive and chief financial officer.

The date of the written representation letter should be the same as the date the financial statements are authorised. It must be obtained and signed before the auditor's report is finalised.

Reliability of written representations

Written representations are client generated, and may be subject to bias. It is therefore, potentially, an unreliable form of audit evidence.

The auditor must consider the reliability of written representations in terms of:

- Concerns about the competence, integrity, ethical values or diligence of management. [ISA 580, 16]
- Inconsistencies with other forms of evidence. [ISA 580, 17]

Steps if written representations are inconsistent with other evidence

- Consider the reliability of representations in general.
- Reconsider the initial risk assessment.
- Consider the need to perform further audit procedures.

[ISA 580, A23]

Tutorial note

In the exam, when obtaining a written representation as a substantive procedure, you must include an explanation of **what** the written representation is for. For example, 'Obtain a written representation from management confirming the completeness of directors' remuneration including the bonus'.

If there are concerns about the competence, integrity, ethical values or diligence of management:

- The auditor must consider whether the engagement can be conducted effectively.
- If they conclude that it cannot then they should withdraw from the engagement, where permitted by laws and regulations.
- If they are not permitted to withdraw they should consider the impact on the auditor's report. It is likely that this would lead to a disclaimer of opinion.

[ISA 580, A24]

Steps if management refuse to provide written representations

Although possibly unreliable, written representations are a necessary and important source of evidence.

If management refuses to provide requested written representations, the auditor should:

- Discuss the matter with management to understand why they are refusing.
- Re-evaluate the integrity of management and consider the effect that this may have on the reliability of other representations (oral or written) and audit evidence in general.
- Consider the implication for the auditor's report.

[ISA 580, 19]

Audit reporting implications

The auditor should issue a disclaimer of opinion if:

- The auditor concludes there is sufficient doubt about the integrity of management which means the written representations are not reliable, or
- Management does not provide the written representations required in relation to confirming their responsibility to prepare the financial statements and to provide the auditor with information, and confirming completeness of transactions.

[ISA 580, 20]

Illustration 2 – Murray Co-written representation letter

Murray Co
1 Murray Mound, Wimbledon
London WN1 2LN

Wimble & Co

2 Court Lane, Wimbledon

London WN1 2LN

1 July 20X5

Dear Wimble & Co,

This written representation is provided in connection with your audit of the financial statements of Murray Co for the year ended December 31, 20X4 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with International Financial Reporting Standards.

We confirm that:

Financial statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 25 November 20X4, for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular, the financial statements give a true and fair view in accordance therewith.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540)
- All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached. (ISA 450)
- The basis and amount of the warranty provision are reasonable. (specific matter)

Information provided

- We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters.
  - Additional information that you have requested from us for the purpose of the audit.
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (ISA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)
- We have disclosed to you all information in relation to settlement of the unfair dismissal, including our intentions thereon. (specific matter)
- We have disclosed to you all information in relation to the constructive dismissal brought by the previous Sales Director, including our intention thereon. (specific matter)

Ed Perry

Edward Perry

Finance Director, Murray Co

Maria Williams

Maria Williams

Managing Director, Murray Co

Test your understanding 3

Smithson Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.

The audit is nearly complete. As audit senior you have reported to the engagement partner that Smithson Co is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, following which a number of clients withdrew their contracts with Smithson Co. A senior employee then left Smithson Co, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company. A cash flow forecast prepared internally shows Smithson Co requiring significant additional cash within the next 12 months to maintain even the current level of services.

Required:

(a) Define 'going concern' and discuss the auditor's and directors' responsibilities in respect of going concern.

(5 marks)

(b) State the audit procedures that may be carried out to try to determine whether or not Smithson Co is a going concern.

(10 marks)

(c) Explain the audit procedures and actions the auditor may take where the auditor has decided that Smithson Co is unlikely to be a going concern.

(5 marks)

(Total: 20 marks)

Test your understanding 4

Potterton Co is a listed company that manufactures body lotions under the 'ReallyCool' brand. The company's year end is 31 March 20X5, and today's date is 1 July 20X5. Profit before taxation is $4 million.

The audit is nearing completion, but two issues remain outstanding:

1 On 27 May 20X5 a legal claim was made against the company on behalf of a teenager who suffered severe burns after using 'ReallyCool ExtraZingy Lotion' in July 20X4. Potterton Co is considering an out-of-court settlement of $100,000 per year for the remaining life of the claimant. However, no adjustment or disclosure has been made in the financial statements.

2 At a board meeting on 30 April 20X5, the directors of Potterton Co proposed a dividend of $2 million. It is highly likely that the shareholders will approve the dividend at the annual general meeting on 3 September 20X5. The directors have recorded the dividend in the draft statement of changes in equity for the year ended 31 March 20X5.

Required:

(a) Explain whether the two outstanding issues are adjusting or non-adjusting events, in accordance with IAS 10 *Events after the Reporting Period*.

(8 marks)

(b) Describe appropriate audit procedures in order to reach a conclusion on the two outstanding issues.

(5 marks)

(c) Explain the likely impact on the audit opinion if the directors refuse to make any further adjustments or disclosures in the financial statements of Potterton Co.

(4 marks)

(Total: 17 marks)

Test your understanding 5

(a) List SIX items that could be included in a written representation.

(3 marks)

(b) List THREE reasons why auditors obtain written representations.

(3 marks)

(Total: 6 marks)

Test your understanding 6

The audit of Leonora Co is nearly complete and you are performing your procedures in respect of going concern. During the audit you have identified several indicators that the company may not be able to continue as a going concern.

1 **In relation to responsibilities for going concern, which of the following is TRUE?**

A The auditor chooses the basis of preparation for the financial statements.

B The client should make adequate disclosure of going concern uncertainties and the auditor should assess the adequacy of them.

C The auditor will make disclosure of going concern uncertainties in the financial statements.

D The auditor will notify the shareholders immediately of any going concern issues identified during the audit.

2 **State whether each of the following statements are true or false in respect of assessing the going concern status of Leonora Co.**

A	The auditor should prepare forecasts to assess whether Leonora Co is likely to be able to continue trading	**True**	**False**
B	The directors of Leonora Co should prepare forecasts for a period of at least 12 months to assess whether the company is likely to be able to continue trading	**True**	**False**
C	If the directors of Leonora Co prepare forecasts for a period of less than 12 months, the auditor should ask them to extend their assessment period	**True**	**False**
D	If the directors of Leonora Co prepare forecasts for a period of less than 12 months, the auditor should extend the assessment period by preparing a forecast for the additional 6 months	**True**	**False**

3 **Which of the following is correct in respect of going concern?**

A All companies must prepare financial statements using the going concern basis of accounting.

B If there are material uncertainties regarding going concern, the financial statements must be prepared on the break up basis.

C Going concern means the company is no longer profitable.

D The directors of the company must disclose material uncertainties regarding going concern in the notes to the financial statements.

4 **Which of the following are indicators of going concern problems?**

(i) Declining revenues.

(ii) Significant outstanding receivables.

(iii) Loan repayments due to be made.

(iv) Declining current and quick ratios.

A (i), (ii) and (iii) only

B (ii), (iii) and (iv) only

C (i), (ii), (iii) and (iv)

D (iii) only

5 **Which of the following procedures is NOT appropriate for obtaining evidence as to whether the going concern basis of accounting is appropriate?**

A Obtain external confirmation from a customer regarding their outstanding balance.

B Examine cash flow forecasts.

C Discuss with management their plans for the future.

D Inspect correspondence with the bank regarding loan or overdraft facilities.

Test your understanding 7

It is 1 July 20X5. You are currently performing subsequent events procedures for the audit of Kookynie Co. From a review of the board minutes you identify that a customer is suing the company for an injury they suffered on the client's premises on 5 April 20X5. The client's year end is 31 March 20X5. The directors are proposing to amend the financial statements to include a provision for the amount of compensation they expect to have to pay to the customer. Legal advice received indicates that the claim is possible to succeed.

1 **Which of the following statements is TRUE with regard to subsequent events?**

A The auditor must perform audit procedures to identify events occurring after the date of the financial statements up to the date the auditor's report is signed that could have an effect on the financial statements

B The auditor does not need to consider any events which occur after the date of the financial statements as it is outside of the reporting period

C The auditor has no responsibility after the auditor's report has been signed, even if they become aware of events occurring which means the opinion is now incorrect

D The auditor only needs to consider subsequent events communicated to them by the directors

2 **Which of the following statements is FALSE in respect of subsequent events?**

A The auditor must ensure the client has complied with IAS 10 *Events After the Reporting Period* when performing the audit of subsequent events

B The auditor must comply with IAS 10 *Events After the Reporting Period* when performing the audit of subsequent events

C The auditor must comply with ISA 560 *Subsequent Events* when performing the audit of subsequent events

D Events after the reporting period may be adjusting or non-adjusting

3 **Which of the following is TRUE in respect of adjusting events?**

A Adjusting events are those events which occur before the auditor's report has been signed

B Adjusting events are those which occur after the year-end date

C Adjusting events are those which occur after the year-end date and provide evidence of a condition existing at the year-end date

D Adjusting events require disclosure in the notes to the financial statements

4 **In respect of the customer's claim, which of the following statements is TRUE?**

A If the claim is probable rather than possible, a provision should be recognised in the financial statements dated 31 March 20X5

B The injury was caused after the year end therefore was not a condition in existence at the year end

C The injury was caused after the year end therefore has no impact on the financial statements being audited

D The claim is an adjusting event and the financial statements should reflect the claim

5 **Which of following procedures would NOT be appropriate in respect of Kookynie Co's subsequent events review?**

A Inspect correspondence from the lawyers regarding the likely outcome of the case and the estimate of compensation if the claim is successful

B Discuss with management the details of the accident giving rise to the claim

C Obtain written representation from management that all known subsequent events have been disclosed to the auditor and reflected in the financial statements

D Telephone the lawyer to discuss further details of the case of which the client may not be aware

Test your understanding 8

You are completing the audit of Balladonia Co and you are waiting for the client to sign and return the written representation letter. The directors have expressed concern about signing the letter. They have stated that the auditor has been provided with all of the information required and therefore do not understand why the written representation is necessary.

1 **State whether each of the following statements is true or false in respect of written representations.**

A	As you have received all other information during the audit, the decision by management not to provide the written representation letter is not an issue that would affect the auditor's report	**True**	**False**
B	A written representation is an important piece of evidence which the auditor must obtain	**True**	**False**
C	A written representation does not need to be obtained if the wording would be the same as last year's written representation	**True**	**False**
D	Failure by management to provide a written representation letter may cast doubt over management integrity	**True**	**False**

2 **Which of the following statements is FALSE?**

A Written representations include confirmation that management has fulfilled its responsibilities in respect of the financial statements and has provided the auditor with all records and information during the audit.

B Written representations should only be relied on where there is limited other evidence available such as matters of judgement or matters confined to management.

C The auditor would obtain a written representation regarding the reasonableness of a depreciation charge as this is an accounting estimate.

D Failure to obtain a written representation is likely to result in a disclaimer of opinion.

3 **Which of the following would be the auditor's first course of action after being informed that management is unwilling to provide the written representation?**

A Discuss the matter with management and try to resolve the issue

B Discuss the matter with those charged with governance and try to resolve the issue

C Discuss the matter with the shareholders and try to resolve the issue

D Modify the audit opinion

4 **A written representation is required from management to confirm they believe the effects of any uncorrected misstatements are immaterial. Which of the following best describes a misstatement?**

A An error in the financial statements

B A fraud which has a material effect on the financial statements

C An omission of a balance from the financial statements

D A difference between what has been reported in the financial statements and what should have been reported in the financial statements

5 **During the audit of Balladonia Co you discovered misstatements totalling $20,000. Profit before tax is $570,000. Which of the following describes the most appropriate course of action?**

A Ignore the misstatements if they are deemed immaterial

B Modify the audit opinion as a result of misstatement

C Request the client to correct the misstatements

D Include an Emphasis of Matter paragraph in the auditor's report to highlight that misstatements are present in the financial statements

7 Chapter summary

Completion and review

Subsequent events

- Active duty up to date of auditor's report
- Passive duty after date of auditor's report
- Ensure client has complied with IAS 10

Evaluation of misstatements

- Assess materiality
- Ask management to correct
- Consider impact on report if not corrected

Going concern

- Ensure appropriate basis of preparation used
- Ensure adequate disclosures have been made of uncertainties
- Consider impact on report

Final analytical procedures

- Ensure FS are consistent with FR framework
- Ensure FS are consistent with auditor's understanding
- Enable the auditor to form an overall conclusion

Review procedures

Ensure:

- Audit plan has been followed or flexed where necessary
- Work has been done properly
- Sufficient appropriate evidence obtained
- ISAs followed

Written representations

- Management responsibilities
  - Prepare FS
  - Provide audit evidence
  - All transactions recorded
- Support other evidence
- Required by other ISAs

Test your understanding answers

Test your understanding 1

To determine whether or not the financial statements should be adjusted in respect of each of the events described, IAS 10 *Events After the Reporting Period* needs to be applied. If the event provides evidence of conditions that existed at the reporting date (an adjusting event), then an adjustment should be made. If the event provides evidence of conditions that arose after the reporting date (a non-adjusting event), no adjustment is required but a disclosure may be necessary if the event is material and non-disclosure would make the financial statements misleading.

The auditor will only require the directors to amend the financial statements for adjusting events if the adjustment is material. When assessing materiality in the exam, it is sufficient to calculate materiality in relation to each measure individually, using the lower end of the thresholds for prudence. If the item is material to one or more of the measures, then it requires adjustment.

1 Golf is Us was placed into administration after the year end, which provides evidence of the recoverability of the receivables balance at the year end. Therefore, this is an **adjusting event**. The total value of the balance is $211,000 which is 2% of total assets and 20% of profit, and is therefore **material**. The receivables balance should be written off or an allowance for receivables created.

2 The sales director left the company after the year end and is suing for constructive dismissal, which is an event that arose after the reporting date. Therefore, this is a **non-adjusting event**. The total value of the claim is $280,000, which is 2.9% of assets and 26.7% of profit before tax and is therefore material. This may also be considered material by nature. The nature of the event and any estimates of the financial impact should therefore be **disclosed**.

3 A fire destroyed inventory after the year end, which is a **non-adjusting event** (as the inventory was not damaged at the year end). The total value of inventory stored at the premises is $1,054,000, which is 11% of total assets and 101% of profit and is therefore **material**. The nature of the event and any estimates of the financial impact should be **disclosed**.

4 After the year end a letter was received offering to settle a claim for unfair dismissal out-of-court. This is an event that provides evidence of the valuation of the provision at the year end and is therefore an **adjusting event**. The current provision is for $40,000 and the adjustment would therefore be $15,000. This is **not material** being 0.15% of total assets and 1.43% profit before tax. Therefore **no adjustment** is necessary.

Test your understanding 2

Going concern indicators at Murray Co:

Indicator	Explanation
A major customer has been placed into administration.	Unless the customer can be replaced, this will result in significant loss of future revenues. The debt outstanding is unlikely to be paid, resulting in a negative impact on cash flow.
The sales director left the company and has yet to be replaced.	Loss of a key director will impact on the company's revenue. As Murray Co has already lost a major customer, without an experienced sales director to generate new business, the company will face significantly reduced revenue and cash flows.
The sales director is suing Murray Co for constructive dismissal.	Murray Co will need to pay expensive legal costs in order to defend this litigation, squeezing cash flows even further. In addition, this may damage the company's reputation and make it difficult to recruit a suitable replacement or other key staff. Any compensation awarded to the sales director will mean further outflow of cash.
Murray Co is seeking new funding through an initial public offering of shares in the company.	If Murray Co does not obtain new funding through a listing, alternative finance will need to be obtained in order to continue to operate. This may not be easy to obtain given the other problems.
Murray Co is operating close to its overdraft limit.	Murray Co is heavily dependent on a short-term source of finance that is repayable on demand. It may be difficult to obtain further sources of finance if the overdraft limit is reached.

The cash flow forecast shows negative monthly cash flows for the next twelve months.	If the company continues to have cash outflows then the overdraft will increase further and there may be no cash available to pay debts as they fall due.
A number of suppliers have been paid late.	If suppliers are paid late they may refuse to supply Murray Co with goods/components or impose cash on delivery terms which will disrupt production, and delay sales to customers. This may result in loss of customers.
The loan facility is secured, in part, on the refurbished assembly line which has broken down.	The bank may withdraw the loan facility if the asset on which it is secured is significantly impaired. Murray Co does not have sufficient cash to repay the loan. Unless Murray Co can negotiate with the bank or raise alternative finance (or sell non-current assets), it will have no realistic alternative but to liquidate.
The assembly line broke down during January, and six weeks later is still not working.	If Murray Co cannot meet customer orders due to manufacturing problems, refunds may have to be given and customer goodwill may be lost. Future revenues may fall which will put further pressure on cash flows.
A fire at the premises of the third party warehouse provider destroyed approximately one half of Murray Co's inventory.	Murray Co may not be able to meet customer orders if it does not have sufficient inventory. If the fire is not covered by insurance, profit and cash flow will be significantly impacted.

Test your understanding 3

(a) **Going concern**

Going concern means that the entity will continue in operational existence for the foreseeable future without the intention or the necessity of liquidation or otherwise ceasing trade.

The auditor's responsibilities are:

- To consider the appropriateness of management's use of the going concern basis of accounting when preparing the financial statements.
- To conclude on whether a material uncertainty exists about the entity's ability to continue as a going concern.
- To report to the members in accordance with ISA 570 *Going Concern*.

The directors are responsible for:

- Preparing the financial statements on an appropriate basis, be that the going concern or the breakup basis.
- Disclosing material uncertainties relating to going concern in the financial statements.

(b) **Audit procedures regarding going concern**

– Obtain a copy of the cash flow forecast and assess the reasonableness of the assumptions used in the forecast.

– Discuss with the directors their view of whether Smithson Co can continue as a going concern. Ask for their reasons and try and determine whether these are reasonable.

– Enquire of the directors whether they have considered any other forms of finance for Smithson Co to make up the cash shortfall identified in the cash flow forecast.

– Obtain a copy of any interim financial statements of Smithson Co to determine the level of sales/income after the year end and whether this matches the cash flow forecast.

– Enquire about the possible lack of capital investment within Smithson Co identified by the employee leaving. Review the purchase policy with the directors.

- Consider the extent to which Smithson Co rely on the senior employee who recently left the company. Ask the HR department whether the employee will be replaced soon.
- Obtain a solicitor's letter and review to identify any legal claims against Smithson Co related to below standard services being provided to clients. Where possible, consider the financial impact on Smithson Co and whether insurance is available to mitigate any claims.
- Review Smithson Co's order book to try and determine the value of future orders compared to previous years.
- Review the bank letter to determine the extent of any bank loans and whether repayments due in the next 12 months can be made without further borrowing.
- Review other events after the end of the financial year and determine whether these have an impact on Smithson Co.
- Obtain a written representation confirming the directors' opinion that Smithson Co is a going concern.

(c) **Audit procedures and actions if Smithson Co is not considered to be a going concern**

- Discuss the situation again with directors. Consider whether additional disclosures are required in the financial statements or whether the financial statements should be prepared on the break-up basis.
- Explain to the directors that if additional disclosure or restatement of the financial statements is not made then the auditor will have to modify the audit opinion.
- Consider implications for the auditor's report. Where the directors provide adequate disclosure of the going concern situation of Smithson Co, then a section should be included in the auditor's report headed 'Material Uncertainty Related to Going Concern' to draw attention to the going concern disclosures.
- Where the directors do not make adequate disclosure of the going concern situation then modify the audit opinion due to material misstatement due to inadequate disclosure.
- The modification will be an 'except for' qualification or an adverse opinion depending on whether the issue is material or material and pervasive.
- The 'Basis for Opinion' section will be amended to 'Basis for Adverse Opinion' or 'Basis for Qualified Opinion' to explain the reason for the modified opinion.

Test your understanding 4

(a) **Analysis of events**

Legal claim

The legal claim is an adjusting event because it provides evidence of a condition existing at the end of the reporting period. As at 31 March 20X5, the claimant had purchased and used the product, and the damage to the claimant's skin had already occurred.

The legal claim is material, because, if the claimant lived for, say, another 40 years, the company would owe $4 million. This is 100% of the current year profit before tax.

Therefore, profit should be reduced and liabilities increased by the expected value of the claim.

Proposed dividend

The proposed dividend is a non-adjusting event because the condition arose after the end of the reporting period. No liability for the dividend can exist until the shareholders approve the dividend.

The proposed dividend is material because it constitutes 50% ($2m/$4m × 100) of the company's profit before tax, as well as being material by nature.

Therefore, the dividend should not be recognised in the financial statements for the year ended 31 March 20X5. However, the proposed dividend should be disclosed in a note to the financial statements.

(b) **Audit procedures**

Legal claim

– Review legal correspondence in order to understand the likely outcome of the legal claim.

– Review customer correspondence/legal files in order to identify other similar claims which could give rise to additional liabilities.

– Discuss with the production director the likely cause of the burns (e.g. allergy in user or inadequate printed instructions on product use) to determine the likelihood of any claim being successful in court.

– Review trade/consumer press to identify whether the claim might damage the reputation of the Reallycool brand which could impact future revenues or even create a going concern threat.

– Propose adjustment of the financial statements to the directors.

Proposed dividend

- Inspect board minutes in order to confirm the amount of the proposed dividend.
- Propose an adjustment to the financial statements to remove the dividend from being recognised in the statement of changes in equity but ensure that the dividend proposal is disclosed within the notes.

(c) **Impact on audit opinion**

- The auditor must modify the audit opinion if the directors refuse to make the relevant adjustments in the financial statements requested by the auditors.
- Both the legal claim (which should have been recognised) and the proposed dividend (which should have been disclosed rather than recognised) are materially misstated.
- The auditor must express a qualified ('except for') opinion if they conclude that the misstatements are material, but not pervasive, to the financial statements.
- The auditor must express an adverse opinion if they conclude that misstatements are both material and pervasive to the financial statements.
- Given the size of the amounts involved, an adverse opinion may be appropriate in these circumstances.

Tutorial note: If the requirement asked for implications for the auditor's report, the following points should also be included in the answer:

- The 'Basis for Opinion' section will be amended to 'Basis for Adverse' or 'Basis for Qualified Opinion' to explain the reason for the modified opinion.

Test your understanding 5

(a) **Items to be included in a written representation letter**

- All books, records and relevant information have been made available to the auditor.
- Financial statements have been prepared in accordance with an applicable financial reporting framework.
- All transactions have been recorded and reflected in the financial statements.
- The effects of uncorrected misstatements are immaterial to the financial statements.
- Any instances of non-compliance with laws and regulations have been disclosed to the auditor.
- The directors believe the company can continue to trade as a going concern.
- The directors have no plans that will materially alter the carrying value or classification of assets or liabilities in the financial statements.
- No plans to abandon any product lines that will result in any excess or obsolete inventory.
- All subsequent events have been disclosed to the auditor and reflected appropriately in the financial statements.
- No irregularities involving management or employees that could have a material effect on the financial statements.

(b) **Reasons why the auditor obtains written representations**

- Formal confirmation by management of their responsibilities.
- To support other evidence relevant to the financial statements if determined necessary by the auditor, e.g. matters requiring management judgement.
- Required by ISA 580 and other ISAs.

Test your understanding 6

1	B	The directors (client) must make the disclosures in the financial statements. The auditor will audit them.
2	A – False	The auditor should review the forecasts prepared by the directors. The auditor should not prepare them.
	B – True	The directors (client) should prepare the forecasts to assist with their assessment of going concern in order to determine the appropriate basis on which to prepare the financial statements.
	C – True	The directors are required to consider at least a 12-month period for their going concern assessment. The auditor must ask them to extend their assessment if they fail to consider at least 12 months.
	D – False	The auditor should not extend the assessment or prepare forecasts for the client.
3	D	The financial statements should be prepared on the break up basis if the company is not a going concern. If there are material uncertainties regarding going concern, these must be disclosed by the directors. A company may be profitable but not have the cash to pay its debts when they fall due.
4	C	All are indicators of going concern problems.
5	A	Obtaining external confirmation from a customer may confirm the balance owed but does not provide evidence that the money will be received.

Test your understanding 7

1	A	The auditor has an active duty up to the date the auditor's report is signed. If they become aware of events after this date that would cause them to modify their opinion they must take action.
2	B	IAS 10 *Events After the Reporting Period* refers to the accounting treatment the client should comply with. The auditor must comply with ISA 560 *Subsequent Events*.
3	C	Adjusting events provide evidence of conditions existing at the year end (IAS 10, 3a).
4	B	As the injury was suffered after the year end it is a non-adjusting event. Therefore, a provision is not required at 31 March 20X5. If it is material, disclosure should be made.
5	D	The auditor has no right to contact the lawyer in this manner. A lawyer confirmation letter may be sent with client permission. It would not be professional for the lawyer to discuss details of the case that are not known to the client with the auditor.

Test your understanding 8

1	A – False	A written representation is required by ISA 580. Without it the auditor does not have sufficient appropriate evidence to form a conclusion and must therefore modify the auditor's opinion.
	B – True	A written representation contains written confirmation from the directors that they have fulfilled their responsibilities in relation to the financial statements and providing the auditor with all of the information required. As such, it is an important piece of evidence.
	C – False	The written representation must be dated just before the date of the auditor's report. Even if the wording is the same, a written representation must be obtained each year.
	D – True	The engagement letter states that written representations will be required. Failure to provide one casts doubt over management integrity as it may indicate that information is being concealed from the auditor.
2	C	Sufficient other evidence is available to assess the reasonableness of depreciation.
3	A	The first course of action would be to try and resolve the issue with management. If that failed, the auditor could discuss the matter with those charged with governance. The shareholders would not be involved in this issue. The audit opinion would be modified if the issue could not be resolved with management or those charged with governance.
4	D	Errors, frauds and omissions are all types of misstatement. Therefore the best description of a misstatement is answer D.
5	C	Even if misstatements are immaterial they should not be ignored altogether. The client will be asked to correct them. There is no need to modify the audit opinion if they remain uncorrected provided the refusal to correct does not indicate the presence of other misstatements. An Emphasis of Matter paragraph is not appropriate in this situation. There is no need to communicate immaterial matters to the users of the financial statements.

Chapter

12

Reporting

Chapter learning objectives

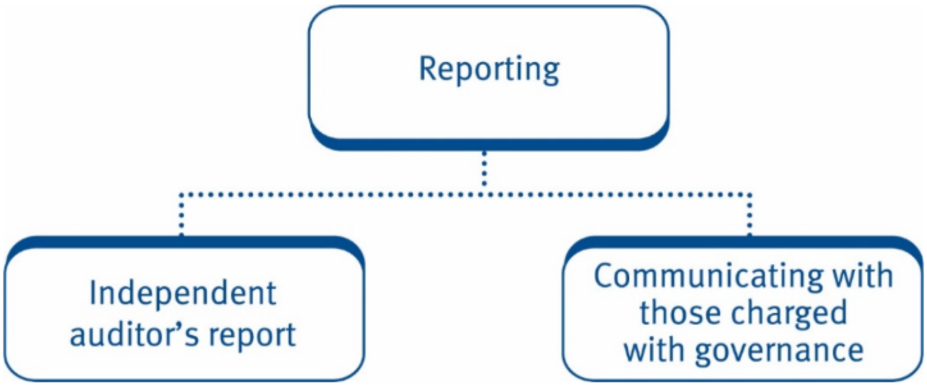
This chapter covers syllabus areas:

- E5 – The Independent Auditor's Report
- C4c – Communicating with those charged with governance

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO20) is to review and report on the findings of an audit. You complete an audit, preparing the formal documentation and reporting any control deficiencies to management. You report back to managers in a formal audit report. Working through this chapter should help you understand how to demonstrate that objective.



1 The independent auditor's report

When the audit work is complete, the auditor will prepare the auditor's report containing an opinion on the financial statements.

The objectives of the auditor are:

- To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained, and
- To express clearly that opinion through a written report.

[ISA 700 *Forming an Opinion and Reporting on Financial Statements*, 6]

The auditor forms an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Below is an illustration of and auditor's report and this chapter goes through each section in turn.

Illustration 1 – Auditor's report

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Murray Co

Report on the Audit of the Financial Statements [sub-title is not included if there is no separate Report on Other Legal and Regulatory Requirements]

Opinion

We have audited the financial statements of the Murray Co (the Company), which comprise the statement of financial position as at 31 December, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X4, and its performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key audit matters [listed companies only]

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701]

[Additional communications – only included if required]

Other information

Management is responsible for the other information. The other information comprises the Chair's statement, but does not include the financial statements and the auditor's report thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Management and Those Charged With Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

[Report on Other Legal and Regulatory Requirements – as required by local law, regulation or national auditing standards]

[Other matter – only included if required]

Wimble & Co

Wimble & Co, London

1 July 20X5

[ISA 700, Appendix]

2 Title and addressee

The title clearly identifies the report as an Independent Auditor's Report.

The addressee identifies the intended user of the report and shows to whom the auditor owes a duty of care.

3 Auditor's opinion

The auditor's opinion provides the auditor's conclusion as to whether the financial statements give a true and fair view.

The audit opinion can be **unmodified or modified**.

Nature of issue	Not material	Material but Not Pervasive	Material & Pervasive
Misstatement	Unmodified opinion True and fair view*	Modified Qualified Opinion Except for ...	Modified Adverse Opinion FS do not give a true and fair view*
Inability to obtain sufficient appropriate audit evidence	Unmodified opinion True and fair view*	Modified Qualified Opinion Except for ...	Modified Disclaimer of Opinion Do not express an opinion

* ISA 700 allows the wording 'true and fair view' or 'fairly presents'.

Unmodified opinion

The auditor will give an unmodified opinion when they conclude that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. [ISA 700, 16]

This will mean:

- The financial statements adequately disclose the significant accounting policies.
- The accounting policies selected are consistently applied and appropriate.
- Accounting estimates made by management are reasonable.
- Information is relevant, reliable, comparable and understandable.
- The financial statements provide adequate disclosures to enable the users to understand the effects of material transactions and events.
- The terminology used is appropriate.

[ISA 700, 13]

Modified opinion

The auditor will need to modify the opinion when they conclude that:

- Based on the evidence obtained, **the financial statements** as a whole **are not free from material misstatement**. This is where the client has not complied with the applicable financial reporting framework.
- They have been **unable to obtain sufficient appropriate evidence** to be able to conclude that the financial statements as a whole are free from material misstatement. This is evidence the auditor would expect to exist to support the figures in the financial statements.

[ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, 6]

The nature of the modification depends on whether the auditor considers the matter to be **material but not pervasive**, or **material and pervasive**, to the financial statements.

Pervasive

A matter is considered '**pervasive**' if, in the auditor's judgement:

- The effects are not confined to specific elements, accounts or items of the financial statements
- If so confined, represent or could represent a substantial proportion of the financial statements, or
- In relation to disclosures, are fundamental to users' understanding of the financial statements.

[ISA 705, 5a]

In brief, a pervasive matter must be fundamental to the financial statements, therefore rendering them unreliable as a whole.

Qualified opinion

- If the misstatement or lack of sufficient appropriate evidence is **material but not pervasive**, a **qualified opinion** will be issued. [ISA 705, 7]
- This means the matter is material to the area of the financial statements affected but does not affect the remainder of the financial statements.
- Although significant to users' decision making, a material matter can be isolated while the remainder of the financial statements may be relied upon.
- The opinion will state that '**Except for**' this matter, the financial statements give a true and fair view.

Illustration 2 – Murray Co Qualified opinion due to misstatement

Qualified Opinion

We have audited the financial statements of Murray Co (the Company), which comprise the statement of financial position as at 31 December, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, **except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements give a true and fair view**.................. *(remainder* of wording as per an unmodified opinion).

Basis for Qualified Opinion

No allowance has been provided in the financial statements for a receivable for which recoverability is in doubt, which, in our opinion, is not in accordance with International Financial Reporting Standards. The allowance for the year ended 31 December 20X4 should be $211,000 based on the value of the receivable in current assets and the likely recoverability of the amount. Accordingly, current assets should be reduced by an allowance of $211,000 and the profit for the year and accumulated profit should be decreased by the same amount.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. **We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.**

Illustration 3 – Murray Co Qualified opinion due to inability to obtain sufficient and appropriate evidence

Qualified Opinion

We have audited the financial statements of the Murray Co (the Company), which comprise the statement of financial position as at 31 December, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, **except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements give a true and fair view**...............(remainder of wording as per an unmodified opinion).

Basis for Qualified Opinion

As described in note 8 to the financial statements, Murray Co is the defendant in a lawsuit alleging constructive dismissal. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The liability has been disclosed as contingent in accordance IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We have been unable to obtain a response to our request for information from the solicitors representing Murray Co in the case. We were unable to confirm or verify by alternative means the likely success of the lawsuit and therefore unable to determine whether disclosure of a contingent liability is appropriate, or whether a provision for the value of the claim of $280,000 should be included in the statement of financial position as at 31 December 20X4 and an associated expense included in the statement of profit or loss for the year ended 31 December 20X4. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. **We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.**

Adverse opinion

An **adverse opinion** is issued when a misstatement is considered **material and pervasive**. [ISA 705, 8]

This will mean the financial statements **do not give a true and fair view**.

Examples include:

- Preparation of the financial statements on the wrong basis.
- Non-consolidation of a material subsidiary.
- Material misstatement of a balance which represents a substantial proportion of the assets or profits e.g. would change a profit to a loss.

e.g

Illustration 4 – Murray Co Adverse opinion

Adverse Opinion

We have audited the financial statements of the Murray Co (the Company), which comprise the statement of financial position as at 31 December, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, **because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not give a true and fair view**.......... (remainder of wording as per an unmodified opinion).

Basis for Adverse Opinion

As explained in note 12 to the financial statements, the financial statements have been prepared on the going concern basis. However, in our opinion, due to the number and significance of the material uncertainties, Murray Co is not a going concern in accordance with IAS 1 *Presentation of Financial Statements* and therefore the financial statements should not be prepared on the going concern basis.... [explanation of the various effects on the amounts presented in the financial statements].

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. **We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.**

Disclaimer of opinion

A **disclaimer of opinion** is issued when the auditor has not obtained sufficient appropriate evidence and the effects of any possible misstatements could be **pervasive**. [ISA 705, 9]

The auditor **does not express an opinion** on the financial statements in this situation.

Examples include:

- Failure by the client to keep adequate accounting records.
- Refusal by the directors to provide written representation.
- Failure by the client to provide evidence over a single balance which represents a substantial proportion of the assets or profits or over multiple balances in the financial statements.

e.g

Illustration 5 – Murray Co Disclaimer of opinion

Disclaimer of Opinion

We were engaged to audit the financial statements of Murray Co (the Company), which comprise the statement of financial position as at 31 December, 20X4, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, **we have not been able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements**.

Basis for Disclaimer of Opinion

Due to a fire at a third party warehouse provider's premises, the records relating to inventory held there were destroyed. We were unable to confirm or verify by alternative means closing inventory of $1,054,000 deducted from cost of sales included in the statement of profit or loss for the year ended 31 December 20X4, and the inventory balance of $1,054,000 included in the statement of financial position as at 31 December 20X4.

As a result, we were unable to determine whether any adjustments to the financial statements might have been necessary in respect of recorded or unrecorded inventory or cost of sales, and the associated elements of the statement of changes in equity and statement of cash flows.

Responsibilities of Management and Those Charged With Governance for the Financial Statements

[Wording as per ISA 700]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the Basis for Disclaimer of Opinion section of our report, we were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Impact of a disclaimer of opinion

Where a disclaimer of opinion is being issued:

- The statement that sufficient appropriate evidence to provide a basis for the auditor's opinion has been obtained is not included.
- The statement that the financial statements have been audited is changed to 'we were engaged to audit the financial statements'.

[ISA 705, 19]

- The statements regarding the audit being conducted in accordance with ISAs, and independence and other ethical responsibilities, are positioned within the Auditor Responsibilities section rather than the Basis for Disclaimer of Opinion section. [ISA 705, A25]
- The Key Audit Matters section is not included in the report as to do so would suggest the financial statements are more credible in relation to those matters which would be inconsistent with the disclaimer of opinion on the financial statements as a whole. [ISA 705, 29]

Management imposed limitation of scope

If management imposes a limitation of scope after the audit has been accepted the auditor must:

- Request that the limitation is removed. [ISA 705, 11]
- If management refuses, communicate with those charged with governance. [ISA 705, 12]
- Perform alternative audit procedures if possible. [ISA 705, 12]
- Issue a qualified audit opinion if the matter is considered material but not pervasive. [ISA 705, 13a]
- Withdraw from the audit if the matter is pervasive. If withdrawal is not possible before issuing the auditor's report, a disclaimer of opinion should be issued. [ISA 705, 13b]

4 Basis for Opinion section

Within a report containing an unmodified or modified opinion

The basis for opinion section refers to the professional standards the auditor has followed in order to be able to form an opinion on the financial statements, to provide confidence to users that the report can be relied upon.

Within a report containing a modified opinion

When the auditor modifies the opinion, the basis for opinion section will explain the reason why the opinion is modified e.g. which balances are misstated, which disclosures are missing or inadequate, which balances the auditor was unable to obtain sufficient appropriate evidence over and why. [ISA 705, 20b]

The title of the section must reflect the type of opinion being issued. Therefore, the auditor must amend the heading 'Basis for Opinion' to 'Basis for Qualified Opinion', 'Basis for Adverse Opinion' or 'Basis for Disclaimer of Opinion', as appropriate. [ISA 705, 20a]

Where a qualified or adverse opinion is being issued, the auditor must amend the statement '...the audit evidence is sufficient and appropriate to provide a basis for the auditor's qualified/adverse opinion.' [ISA 705, 25]

If possible, a quantification of the financial effect of the modification will be included. [ISA 705, 21]

If the material misstatement relates to narrative disclosures, an explanation of how the disclosures are misstated should be included, or in the case of omitted disclosures, the disclosure should be included if the information is readily available. [ISA 705, 22]

Nature of issue	Not material	Material but Not Pervasive	Material & Pervasive
Misstatement	Unmodified opinion True and fair view Basis for opinion	Modified Qualified Opinion Except for ... Basis for qualified opinion	Modified Adverse Opinion FS do not give a true and fair view Basis for adverse opinion
Inability to obtain sufficient appropriate audit evidence	Unmodified opinion True and fair view Basis for opinion	Modified Qualified Opinion Except for ... Basis for qualified opinion	Modified Disclaimer of Opinion Do not express an opinion Basis for disclaimer of opinion

5 Key Audit Matters section

ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* requires auditors of **listed companies** to determine key audit matters and to communicate those matters in the auditor's report. [ISA 701, 5]

Key audit matters are those that in the auditor's professional judgement were of most significance in the audit and are selected from matters communicated to those charged with governance.
[ISA 701, 8]

The auditor of a non-listed entity may voluntarily, or at the request of management or those charged with governance, include key audit matters in the auditor's report.

The purpose of including these matters is to assist users in understanding the entity, and to provide a basis for the users to engage with management and those charged with governance about matters relating to the entity and the financial statements. [ISA 701, 3]

Each key audit matter should describe why the matter was considered to be significant and how it was addressed in the audit.

Key audit matters include:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*.
- Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

[ISA 701, 9]

Specific examples include:

- Significant fraud risk
- Goodwill
- Valuation of financial instruments
- Fair values
- Effects of new accounting standards
- Revenue recognition
- Material provisions such as a restructuring provision
- Implementation of a new IT system, or significant changes to an existing system.

Illustration 6 – Key Audit Matter

Integrated website and finance systems	How our audit addressed the Key Audit Matter
During the year the company introduced a new website which enables customers to order online. The website is integrated with the finance system. There is a risk of material misstatement in relation to completeness of revenue.	• Obtaining an understanding of the new system and the controls management implemented to ensure the system works effectively. • Testing controls over the new website and finance system. • Performing substantive tests of detail over completeness of income.

Note that a matter giving rise to a qualified or adverse opinion, or a material uncertainty related to going concern are by their nature key audit matters. However, they would not be described in this section of the report. Instead, a reference to the Basis for qualified or adverse opinion or the going concern section would be included. [ISA 701, 15]

If there are no key audit matters to communicate, the auditor shall:

- Discuss this with the engagement quality reviewer, if one has been appointed.
- Communicate this conclusion to those charged with governance. [ISA 701, 17b]
- Explain in the key audit matters section of the auditor's report that there are no matters to report. [ISA 701, 16]

6 Additional communications

In certain circumstances auditors are required to make additional communications in the auditor's report even though the financial statements show a true and fair view. Issues requiring communication include:

- **Material Uncertainty Related to Going Concern** (ISA 570 *Going Concern*)
- **Emphasis of Matter paragraph** (ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in an Auditor's Report*)
- **Other Matter paragraph** (ISA 706)

It is important to note that these **do not impact the wording of the opinion** and do not constitute either a qualified, adverse or disclaimer of opinion.

Material Uncertainty Related to Going Concern

This section is included when there is a material uncertainty regarding the going concern status which the directors have adequately disclosed in the financial statements. The auditor uses this section to draw the attention of the user to the client's disclosure note. [ISA 570, 22]

Illustration 7 – Material Uncertainty Related to Going Concern
We draw attention to Note 6 in the financial statements, concerning the uncertainty of Murray Co's future funding. The Company is seeking new funding through an initial public offering of shares. In the event that the initial public offering does not proceed, this will require the Company's existing banking arrangements to be renegotiated and additional funding to be raised from either existing or new investors. This condition indicates the existence of a material uncertainty which may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not include any adjustments that would result if the Company was unable to continue as a going concern. Our opinion is not modified in respect of this matter.

Emphasis of Matter paragraph

An Emphasis of Matter paragraph is used to refer to **a matter that has been appropriately presented or disclosed in the financial statements** by the directors. The auditor's judgement is that these matters are **of such fundamental importance to the users' understanding** of the financial statements that the auditor should emphasise the disclosure. [ISA 706, 7a]

Examples of such fundamental matters include:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event occurs between the date of the financial statements and the date of the auditor's report.
- Early application of a new accounting standard.
- Major catastrophes that have had a significant effect on the entity's financial position.

[ISA 706, A5]

In addition, an Emphasis of Matter paragraph will be used where:

- The financial statements have been prepared on a basis other than the going concern basis.
- The corresponding figures have been restated.
- The financial statements have been recalled and reissued or when the auditor provides an amended auditor's report.

Illustration 8 – Emphasis of Matter Paragraph

We draw attention to Note 12 of the financial statements, which describes the effects of a fire at the premises of a third party warehouse provider. Our opinion is not modified in respect of this matter.

Position in the auditor's report

An Emphasis of matter paragraph is usually included after the Basis for Opinion section. When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgement as to the relative significance of the information included in the Emphasis of Matter paragraph.

The heading of the paragraph can be amended to provide further context, for example, Emphasis of Matter – Subsequent event. [ISA 706, A16]

Tutorial notes

An Emphasis of Matter paragraph is not used to draw attention to immaterial misstatements. The fact that they are immaterial means they do not warrant the attention of the shareholders.

An Emphasis of Matter paragraph can only be used when adequate disclosure has been made of the matters mentioned above. The auditor can only emphasise something that is already included. Where adequate disclosure has not been made the opinion will need to be modified and an Emphasis of Matter paragraph should NOT be used.

An Emphasis of Matter should not be used to highlight an issue already included in the Key Audit Matters section. The auditor must use judgement to determine which section they consider is the most appropriate to highlight the issue.

Other Matter paragraph

An Other Matter paragraph is included in the auditor's report if the auditor considers it necessary to communicate to the users regarding **matters other than those presented or disclosed in the financial statements** that, in the auditor's judgement, are **relevant to understanding the audit, the auditor's responsibilities, or the auditor's report**.
[ISA 706, 7b]

Examples of its use include:

- To communicate that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties. [ISA 706, A14]
- When law, regulation or generally accepted practice requires or permits the auditor to provide further explanation of their responsibilities. [ISA 706, A11]

- To explain why the auditor has not resigned, when a pervasive inability to obtain sufficient appropriate evidence is imposed by management (e.g. denying the auditor access to books and records) but the auditor is unable to withdraw from the engagement due to legal restrictions. [ISA 706, A10]
- To communicate audit planning and scoping matters where laws or regulations require. [ISA 706, A9]
- Where an entity prepares one set of accounts in accordance with a general purpose framework and another set in accordance with a different one (e.g. one according to UK and one according to International standards) and engages the auditor to report on both sets. [ISA 706, A13]

Illustration 9 – Other Matter Paragraph

The financial statements of Murray Co for the year ended December 31, 20X3, were audited by another auditor who expressed an unmodified opinion on those statements on May 31, 20X4.

Position in the auditor's report

When an Other Matter paragraph is included to draw the users' attention to a matter relating to other reporting responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.

When relevant to all auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the Report on the Other Legal and Regulatory Requirements.

The heading may be amended to provide further context, for example, Other Matter – Scope of the audit.
[ISA 706, A16]

Tutorial note

An Other Matter paragraph does not include confidential information or information required to be provided by management. [ISA 706, A15]

7 Other Information section

Other information refers to financial or non-financial information, other than the financial statements and auditor's report thereon, included in the entity's annual report.
[ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*, 12c]

Examples of other information include:

- Chair's report
- Operating and financial review
- Social and environmental reports
- Corporate governance statements.

If the auditor obtains the final version of the other information before the date of the auditor's report, they must read it to identify any material inconsistencies with the financial statements or the auditor's knowledge obtained during the audit. [ISA 720, 3]

If the auditor identifies a material inconsistency they should:

- Perform procedures to evaluate the inconsistency. The auditor should consider whether it is the financial statements or the other information that requires amendment. [ISA 720, 16]
- Discuss the matter with management and ask them to make the correction. [ISA 720, 17]
- If management refuses to make the correction, communicate the matter to those charged with governance. [ISA 720, 17b]
- If the matter remains uncorrected the auditor must describe the material misstatement in the Other Information section of the auditor's report. [ISA 720, 18a]
- Alternatively, the auditor should withdraw from the engagement if possible under applicable law or regulation as the issue casts doubt over management integrity. [ISA 720, 18b]

The Other Information section within the auditor's report:

- Identifies the other information obtained by the auditor prior to the date of the auditor's report.
- States that the auditor has not audited the other information and accordingly does not express an opinion or conclusion on that information.
- Includes a description of the auditor's responsibilities with respect to the other information.
- States either that the auditor has nothing to report or provides a description of the material misstatement if applicable.

[ISA 720, 22]

Purpose

The auditor must not be knowingly associated with information which is misleading. [ISA 720, 4]

Misstatement of other information exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter). [ISA 720, 12b]

Material misstatements or inconsistencies in the other information may undermine the credibility of the financial statements and the auditor's report. [ISA 720, 3]

Tutorial notes

The auditor must retain a copy of the final version of the other information on the audit file. [ISA 720, 25b]

If the auditor issues a disclaimer of opinion on the financial statements, the Other Information section should not be included in the auditor's report as to do so may overshadow the disclaimer of opinion. [ISA 720, A58]

8 Responsibilities of management and auditors

The responsibilities of management and auditors are included to help minimise the expectation gap.

The section on management responsibilities clarifies that management is responsible for preparing the financial statements and for the internal controls.

The section on auditor's responsibilities clarifies that the auditor is responsible for expressing reasonable assurance as to whether the financial statements give a true and fair view and express that opinion in the auditor's report. The section also describes the auditor's responsibilities in respect of risk assessment, internal controls, going concern and accounting policies.

9 Report on Other Legal and Regulatory Requirements

This section highlights any additional reporting responsibilities, if applicable. This may include responsibilities in some jurisdictions to report on the adequacy of accounting records, internal controls over financial reporting, or other information published with the financial statements such as the Strategic Report in the UK.

10 Signature, auditor's address and date

The signature identifies the audit firm responsible for the auditor's report and opinion. If the company is a listed company, the report would include the name of the engagement partner.

The auditor's address identifies the specific office of the engagement partner responsible for the report in case of any queries.

The date identifies the date up to which the audit work has been performed. Any information that comes to light after this date will not have been considered by the auditor when forming their opinion. The report must be signed and dated after the date the directors approved the financial statements. Often, the financial statements are approved and the auditor's report signed on the same day.

Going concern reporting implications

Situation	Impact on audit opinion	Impact on auditor's report
No material uncertainty exists regarding going concern.	Unmodified – Financial statements give a true and fair view.	No impact.
Material uncertainty exists and is adequately disclosed by management.	Unmodified – Financial statements give a true and fair view.	Additional communication: 'Material Uncertainty Related to Going Concern'.
Material uncertainty exists which is not adequately disclosed or is omitted.	Modified – qualified or adverse.	Basis for qualified/adverse opinion will explain the going concern issues management has failed to disclose adequately.
Company is not a going concern and has prepared the financial statements on the break up basis appropriately and made adequate disclosure of this fact.	Unmodified – Financial statements give a true and fair view.	Additional communication: Emphasis of matter paragraph.
Company is not a going concern and has prepared the financial statements using the going concern basis of accounting.	Modified – adverse opinion.	Basis for adverse opinion will explain the incorrect basis of accounting has been used and quantify the effect of this on the financial statements.
The period assessed by management is less than twelve months from the statement of financial position date and management is unwilling to extend the assessment.	Modified – qualified or disclaimer due to an inability to obtain sufficient appropriate audit evidence regarding the use of the going concern basis of accounting.	Basis for qualified/disclaimer opinion explaining that sufficient appropriate evidence was not obtained to form a conclusion on whether the going concern basis of preparation is appropriate.

Exam question approach

The exam will regularly feature a requirement asking for the implications for the auditor's report if issues identified during the audit are not resolved. The following approach should be taken to answer this type of requirement.

Explain the implications for the auditor's report

1 Materiality assessment – if the issue is not material it won't affect the auditor's report. Calculate the percentage of assets and profit the issue represents and state whether this is material or not material.

2 Identify the type of issue

- Material misstatement – non-compliance with an accounting standard.
- Inability to obtain sufficient appropriate evidence – evidence the auditor would expect to obtain hasn't been obtained.
- Material uncertainty – significant events where the outcome will only be known in the future.
- Inconsistency with the other published information – contradiction between the financial statements and the other information which is not subject to audit e.g. chair's statement, corporate social responsibility (CSR) report, etc.
- A matter that is of importance to the scope of the audit, the auditor's assessment of materiality, assessment of risk of material misstatement or other key audit matter that the auditor should specifically refer to in their report.

3 Comment on the issue

- Which accounting standard has not been complied with and why?
- Which piece of evidence has not been obtained and why?
- What event/outcome is uncertain?
- What is the contradiction in the unaudited information?
- Explain why the auditor focused specifically on the key audit matters described in greater detail in the auditor's report e.g. involved a high degree of management judgement, required complex accounting treatment creating significant risk of material misstatement.

4 State whether the issue is material but not pervasive or material and pervasive. If it is isolated or relatively small in impact it will be material but not pervasive. If it makes the financial statements as a whole unreliable it will be material and pervasive.

5 Conclude on the opinion

– Unmodified if there are no material misstatements and sufficient appropriate evidence has been obtained, or

– Modified if there is material misstatement or the auditor has been unable to obtain sufficient appropriate evidence.

6 State the name of opinion and the key wording of that opinion

– Unmodified – 'The financial statements give a true and fair view'

– Qualified – 'Except for the matter described in the basis for opinion, the financial statements give a true and fair view'

– Adverse – 'The financial statements do not give a true and fair view'

– Disclaimer – 'The auditor does not express an opinion'

Tutorial Note: Do not list every possible opinion. Select the one which is most appropriate for the situation.

7 State any other reporting implications

– Basis for modified opinion if the opinion is modified

– Material Uncertainty Related to Going concern section

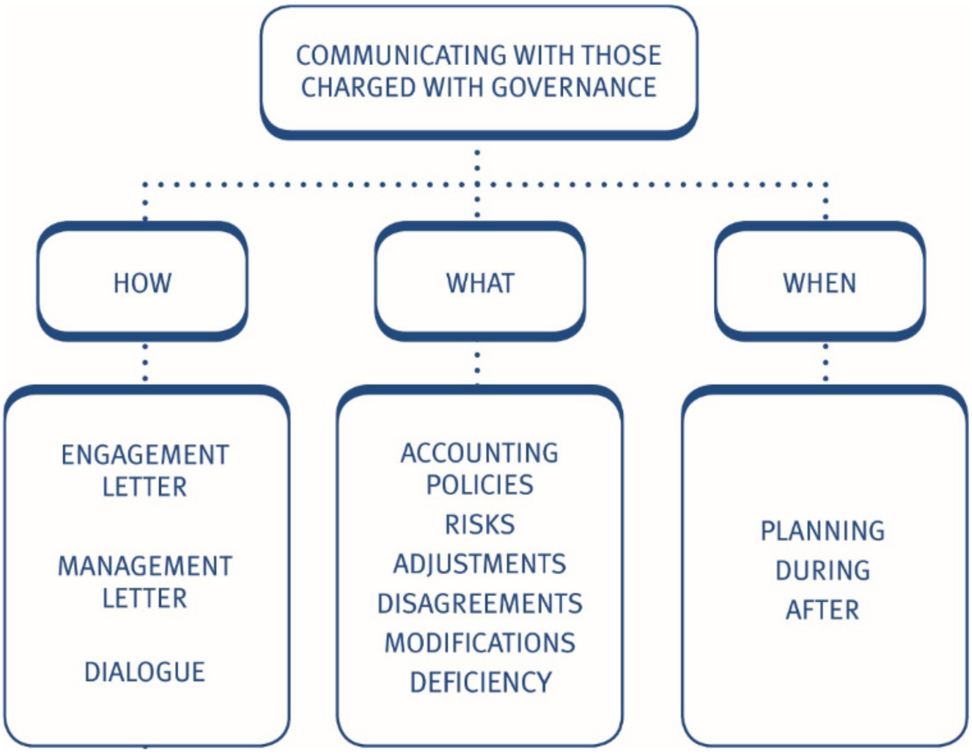
– Emphasis of Matter paragraph

– Other Matter paragraph

– An inconsistency needs to be described in the Other Information section

– Requires inclusion in the Key Audit Matters section for a listed entity.

11 Communicating with those charged with governance



ISA 260 *Communication with Those Charged with Governance* and ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, require the external auditor to engage in communications with management.

The main forms of formal communication between the auditors and management are: the engagement letter (see 'Ethics and Acceptance' chapter); and another written communication, usually sent at the end of the audit, which is often referred to as 'the management letter.'

In addition, the auditor will communicate with those charged with governance throughout the audit as required.

Reasons for communicating with those charged with governance

- To communicate responsibilities of the auditor and an overview of the scope and timing of the audit.
- To obtain information relevant to the audit.
- To report matters from the audit on a timely basis.
- To promote effective two-way communication.

[ISA 260, 9]

Matters to be communicated

- The auditor's responsibilities in relation to the financial statements audit. [ISA 260, 14]
- The planned scope and timing of the audit including, for example:
  - How the auditor plans to address the risks of material misstatement
  - The application of materiality in the context of an audit
  - Preliminary views about matters which may be key audit matters
  - The auditor's approach to the entity's system of internal control
  - The extent to which the auditor is planning to use the work of internal audit and the arrangements for so doing
  - Business risks that may result in material misstatements
  - Communications with regulators.

  [ISA 260, 15, A13, A14]
- Significant findings from the audit, such as:
  - The auditor's views about qualitative aspects of the entity's accounting practices/policies
  - Significant difficulties encountered during the audit
  - Significant matters arising during the audit that were discussed with management
  - Written representations the auditor is requesting
  - Circumstances that affect the form and content of the auditor's report, if any. This includes any expected modifications to the opinion, key audit matters and material uncertainty related to going concern
  - Other matters that, in the auditor's opinion, are significant to the oversight of the reporting process.

  [ISA 260, 16 & A24]
- Matters of auditor independence including:
  - A statement that the firm has complied with ethical requirements,
  - Professional fees for audit and non-audit services charged during the period
  - Safeguards applied to eliminate or reduce threats to independence.

  [ISA 260, 17]

Ultimately what constitutes a matter requiring the attention of those charged with governance is a matter of professional judgement. Typical examples include:

- Delays in obtaining information for the audit.
- An unreasonably brief time within which to complete the audit.
- Expected limitations on the audit, either imposed by management or other circumstances.
- The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.
- A summary of identified misstatements, whether corrected or not by the entity and a request that they are adjusted.
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Any other matters agreed upon in the terms of the audit engagement.

Timing of communication with those charged with governance

Stage of audit	Communication required
Planning	Significant risks identified by the auditor. How the auditor plans to address the risks. Auditor's approach to internal control relevant to the audit. Application of materiality in the context of an audit.
During the audit	If any situation occurs and it would not be appropriate to delay communication until the audit is concluded.
Conclusion of the audit	Major findings from the audit work. Delays caused by management.

The auditor must take care not to compromise the effectiveness of the audit by communicating too much information about the planned scope and timing of the audit to such an extent that procedures become too predictable.

Test your understanding 1

Murray case study: Auditor's report

As a result of the going concern review undertaken at the completion stage, the audit engagement partner has decided that there is a material uncertainty regarding the going concern status of Murray Co. The partner has requested that the directors make adequate disclosure in the final version of the financial statements for the year ended 31 December 20X4.

Required:

Describe the impact on the auditor's report for the year ended 31 December 20X4 if:

(i) The directors include disclosure regarding the material uncertainty over going concern, which in the partner's view is adequate.

(3 marks)

(ii) The directors refuse to include any disclosure on the matter.

(3 marks)

(Total: 6 marks)

Test your understanding 2

ISA 260 *Communication with Those Charged with Governance* deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements.

Required:

(i) Describe TWO specific responsibilities of those charged with governance.

(2 marks)

(ii) Explain FOUR examples of matters that might be communicated to them by the auditor.

(4 marks)

(Total: 6 marks)

Test your understanding 3

Henry

(a) Aragon Co uses a perpetual inventory system. No year-end count is performed. You have reviewed the level of adjustments made each month after each perpetual count and concluded that due to the significance of the adjustments, the inventory system is not reliable. You have requested that a full year-end count is performed but management has refused saying it would be too disruptive. The inventory balance is $4 million. Sales revenue is $50 million and profit for the year is $15 million.

(b) Boleyn Co has not made allowance for an irrecoverable debt of $50,000 in respect of a customer declared bankrupt just after the year end. Profit for the year is $500,000.

(c) Seymour Co is being sued by a competitor for the theft of intellectual property. The amount of the claim is material and the case could go either way. The claim is not mentioned anywhere in the financial statements.

(d) Howard Co is a cash retailer. There is no system to confirm the accuracy of cash sales.

(e) Cleves Co has neglected to include a statement of profit or loss in its financial statements.

(f) Parr Co is involved in a major court case that would bankrupt the company if lost. The directors assess and disclose the case as a contingent liability in the accounts. The auditor agrees with the treatment and disclosure.

Required:

For each of the above situations describe the implications for the independent auditor's report.

(18 marks)

Test your understanding 4

You are the audit manager of Brakes Co, a listed client. Brakes Co is a global manufacturer of braking systems for use in domestic and commercial motor vehicles. $250,000 was raised through a new share issue in the year. Draft profit before tax is $9m and total assets are $37m. The audit is nearly complete and you are undertaking an overall review of the audit evidence on file.

(a) **Explain the importance of the overall review of evidence obtained.**

(3 marks)

(b) During your review you notice that the section of the file relating to equity (share capital and reserves) is incomplete.

Required:

Describe audit procedures that should be performed in respect of Brake Co's equity.

(4 marks)

(c) The following matters arising during the audit of Brakes Co have been noted on file for your attention:

(i) A customer of Brakes Co had to withdraw one of its family car models this year due to concerns over the safety of the braking system. The customer has lodged a legal claim against Brakes Co for $10 million for the negligent supply of faulty braking systems. The company's lawyers believe that there is an 80% chance that Brakes Co will lose the case but the directors believe that their quality control procedures have always been robust and that the braking systems will be proven to have been safe. They have however decided to disclose the matter in the financial statements as a contingent liability.

(5 marks)

(ii) Brakes Co also produces and sells brake fluid. Another customer has recently returned a small batch of brake fluid because the fluid appeared to be contaminated with oil. Brakes Co issued the customer with a credit note for the full value of $137,500 and correctly accounted for this in the draft financial statements. As the brake fluid was returned before the year end, Brakes Co has included it in the year-end inventory listing at cost of $125,000. Brakes Co may be able to re-filter and re-sell the brake fluid at the original selling price, but filtering will cost a further $62,500.

(4 marks)

(iii) Four months ago, Brakes Co began renting some additional warehouse space from a third party storage provider, Wheels Co. At the year end, raw materials with a value of $3.2 million belonging to Brakes Co were stored at Wheels Co's premises. The directors of Brakes Co did not make you aware of the new third party storage facility. Consequently, no audit procedures were performed to verify the raw materials.

(4 marks)

Required:

Discuss each of these issues and describe the impact on the independent auditor's report if the above issues remain unresolved.

Note: The mark allocation is shown against each of the three issues above.

(13 marks)

(Total: 20 marks)

Test your understanding 5

You are about to issue the auditor's report for Exmouth Co, a listed client. Half way through the year the company suffered a major computer systems failure which destroyed the accounting records for the year to date. Backups had not been kept and so the company has had to reconstruct the figures for the first six months.

1 **Which opinions are most appropriate for Exmouth Co?**

A Qualified or adverse

B Unmodified or adverse

C Unmodified or disclaimer

D Qualified or disclaimer

2 **What is the purpose of the Basis for Opinion paragraph in an auditor's report which contains an unmodified opinion?**

A To state the opinion on the financial statements

B To confirm the audit has been conducted in accordance with ISAs and ethical requirements

C To highlight a material uncertainty related to going concern which has been adequately disclosed

D To highlight management's responsibilities to the users of the financial statements

3 **Which of the following shows the correct order of the elements to be included in the auditor's report of Exmouth Co?**

A Opinion, date, auditor's address, signature

B Title, opinion, signature, key audit matters

C Addressee, opinion, auditor's responsibilities, date

D Responsibilities of management, basis for opinion, date, addressee

4 **Which of the following describes the wording of a disclaimer of opinion?**

A The financial statements give a true and fair view

B The financial statements do not give a true and fair view

C The auditor does not express an opinion on the financial statements

D Except for the matter described, the financial statements give a true and fair view

5 **Which of the following statements is correct in relation to the auditor's report of Exmouth Co?**

A The Key Audit Matters section should be used to describe the matter giving rise to the modified opinion, in this case that the auditor has been unable to obtain sufficient appropriate evidence

B If a disclaimer of opinion is to be issued, the Key Audit Matters section should not be included in the auditor's report as to do so may suggest other aspects of the financial statements are reliable

C An Emphasis of Matter paragraph should be included to draw attention to the inability to obtain sufficient appropriate evidence

D The auditor will conclude that the financial statements do not give a true and fair view

Test your understanding 6

You are about to issue the auditor's report for two listed clients, Kalgoorlie Co and Cundeelee Co. The financial statements show the following:

	Kalgoorlie	Cundeelee
	$000	$000
Profit before tax	10	245
Uncorrected misstatements:		
Overstatement of receivables due to an irrecoverable debt not being written off	15	
Overstatement of inventory due to failure to value at lower of cost and NRV		85

1 **Which of the following is the most appropriate opinion for Kalgoorlie Co?**

A Adverse

B Disclaimer

C Qualified

D Unmodified

2 **Which of the following is the most appropriate opinion for Cundeelee Co?**

A Adverse

B Disclaimer

C Qualified

D Unmodified

3 **If the misstatement of inventory had been $10,000 instead of $85,000, which is the most appropriate opinion for Cundeelee Co?**

A Adverse opinion

B Unmodified opinion with emphasis of matter

C Qualified opinion

D Unmodified opinion

4 **You have also identified a material uncertainty related to going concern during your audit of Kalgoorlie Co. This has been adequately disclosed by management. How will this impact the auditor's report?**

A The report should include a section titled 'Emphasis of Matter' which will refer to the management's disclosure note

B The report should include a section titled 'Material Uncertainty Related to Going Concern' which will refer to the management's disclosure note

C The report should include a section titled 'Going concern issues' which will refer to the management's disclosure note

D As management has adequately disclosed the uncertainty related to going concern, the auditor does not need to refer to the matter as the financial statements include the appropriate information

5 Included within the financial statements of Cundeelee Co is a provision for a legal case of which the outcome is uncertain at this date. Adequate disclosure of the matter has been included by management. The case represents a significant uncertainty and you have included an emphasis of matter in the auditor's report to refer to the client's disclosure of the uncertainty.

What other implications will there be for the auditor’s report, if any, in respect of this matter?

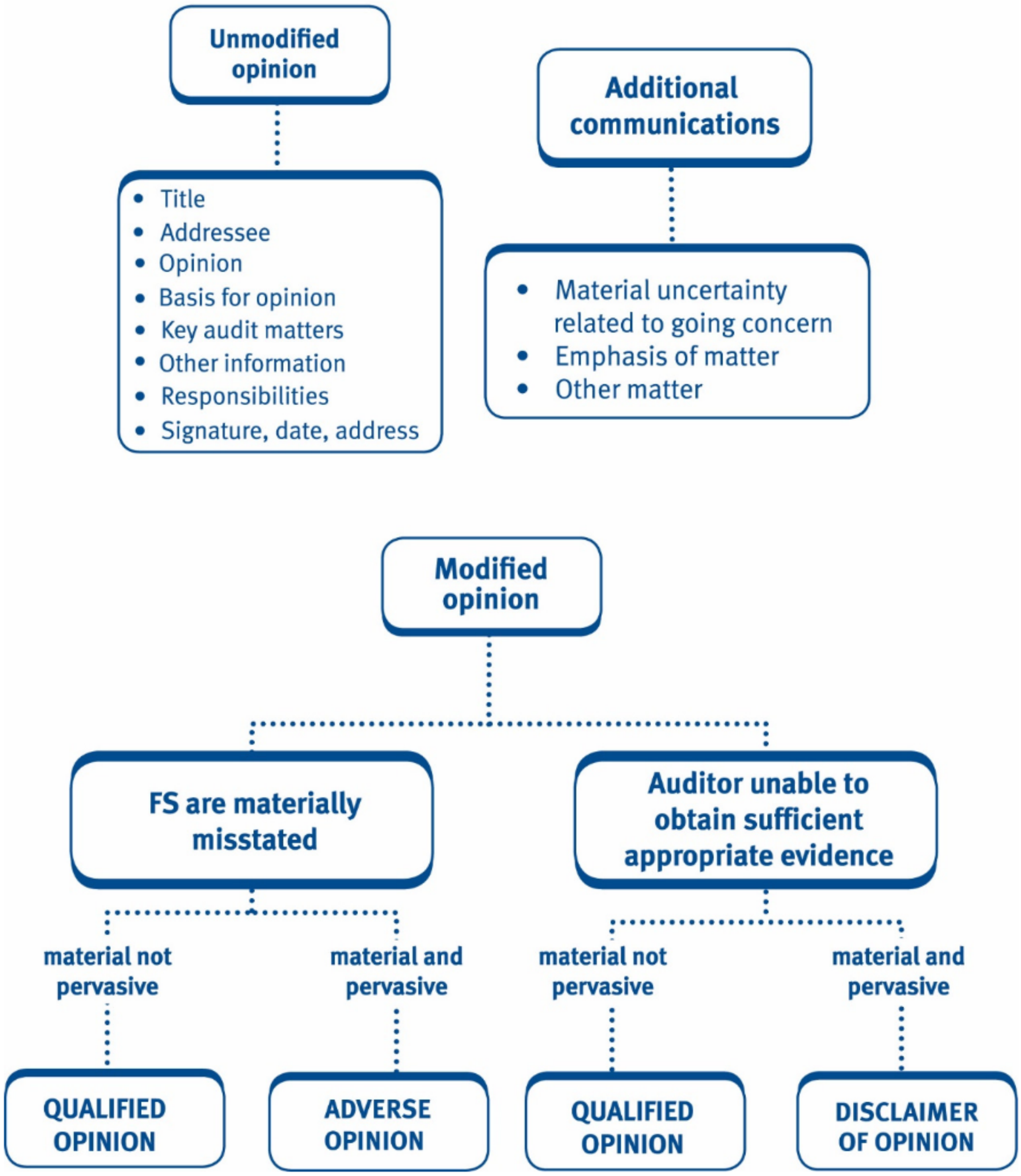
A The opinion should be modified as a result of the significant uncertainty

B No further reporting implications

C The Key Audit Matters section should describe the uncertainty

D The Basis for Opinion section should describe the uncertainty

12 Chapter summary



Test your understanding answers

Test your understanding 1

(i) If the directors make adequate disclosures regarding the material uncertainty over the going concern status of Murray Co, the financial statements will show a true and fair view.

As there is no material misstatement, or lack of sufficient appropriate evidence on this matter, the audit opinion can remain unmodified.

Additional communication will be required in the form of a Material Uncertainty Related to Going Concern paragraph. This will draw the shareholder's attention to the disclosure note.

The paragraph will state that our opinion is not modified in this respect.

The paragraph will be inserted below the basis for opinion paragraph.

(ii) If the directors refuse to make any disclosures, then in the auditor's opinion, the financial statements are materially misstated.

The audit opinion will need to be modified due to this material misstatement.

The type of opinion given depends on whether the auditor considers the misstatement to be material and pervasive or material but not pervasive.

If it is pervasive, an adverse opinion will be given. The opinion will state 'In our opinion the financial statements do not give a true and fair view/are not fairly presented'.

If it is not considered pervasive, a qualified opinion will be given. The opinion will state 'Except for the matter described in the basis for qualified opinion paragraph below, in our opinion the financial statements show a true and fair view/are fairly presented'.

The basis for opinion paragraph will need to change to a basis for qualified/adverse opinion and will explain the reason for the modified opinion.

Test your understanding 2

(i) Those charged with governance are responsible for overseeing:

- The strategic direction of the entity
- Obligations related to the accountability of the entity. This includes overseeing the financial reporting process
- Promotion of good corporate governance
- Risk assessment processes
- The establishment and monitoring of internal controls
- Compliance with applicable law and regulations
- Implementation of controls to prevent and detect fraud and errors.

(ii) General audit matters that might be communicated to those charged with governance are:

1. The auditor's responsibilities in relation to financial statement audit. This includes:
   - A statement that the auditor is responsible for forming and expressing an opinion on the financial statements.
   - That the auditor's work is carried out in accordance with ISAs and in accordance with local laws and regulations.
2. Planned scope and timing of the audit. This includes:
   - The audit approach to assessing the risk of serious misstatement, whether arising from fraud or error.
   - The audit approach to the internal control system and whether reliance will be placed on it.
   - The timing of interim and final audits, including reporting deadlines.
3. Significant findings from the audit. This includes:
   - Significant difficulties encountered during the audit, including delays in obtaining information from management.
   - Significant deficiencies in internal control and recommendations for improvement.
   - Audit adjustments, whether or not recorded by the entity, that have, or could have, a material effect on the entity's financial statements. For example, the bankruptcy of a material receivable shortly after the year end that should result in an adjusting entry.

4 A statement on independence issues affecting the audit. This includes:

- That the audit firm has ensured that all members of the audit team have complied with ethical requirements.
- That appropriate safeguards are in place where a potential threat to independence has been identified.

Test your understanding 3

(a) **Aragon**

- Inventory is material as it represents 8% of sales revenue and 27% of profit.
- There is a lack of sufficient appropriate audit evidence over inventory. The auditor cannot form a conclusion as to whether inventory is materially misstated or free from material misstatement.
- The audit opinion will be modified.
- A qualified opinion using the 'except for' wording will be issued as the matter is material but not pervasive.
- The basis for opinion section will be amended to basis for qualified opinion.
- The basis for qualified opinion section will explain the reason for the qualified opinion and quantify the effect of the issue on the financial statements.

(b) **Boleyn**

- The balance is material as it represents 10% of profit.
- An irrecoverable debt has not been written off. The financial statements will be materially misstated due to overstatement of receivables.
- The audit opinion will be modified.
- A qualified opinion using the 'except for' wording will be issued as the matter is material but not pervasive.
- The basis for opinion section will be amended to basis for qualified opinion.
- The basis for qualified opinion section will explain the reason for the qualified opinion and quantify the effect of the issue on the financial statements.

(c) **Seymour**

- The claim is material and represents an uncertainty that should be communicated to the users of the financial statements.
- As the claim could go either way, a contingent liability should be disclosed. Failure to do this will mean the financial statements are materially misstated.
- The audit opinion will be modified.
- A qualified opinion using the 'except for' wording will be issued as the matter is material but not pervasive.
- The basis for opinion section will be amended to basis for qualified opinion.
- The basis for qualified opinion section will explain the reason for the qualified opinion and quantify the effect of the issue on the financial statements.

(d) **Howard**

- There is no system to confirm cash sales therefore the auditor cannot form a conclusion as to whether revenue is materially misstated or free from material misstatement.
- The auditor is unable to obtain sufficient appropriate evidence for a significant class of transactions in the financial statements.
- The issue is material and pervasive.
- The audit opinion will be modified.
- A disclaimer of opinion will be issued stating that the auditor does not express an opinion on the financial statements.
- The basis for opinion section will be amended to a basis for disclaimer of opinion.
- The basis for disclaimer of opinion section will explain the reason for the disclaimer and quantify the effect of the issue on the financial statements.
- The statement referring to the audit being conducted in accordance with ISAs and ethical requirements will be moved from the basis for opinion section and included in the Auditor responsibilities section.
- The statement within the auditor's report that sufficient appropriate evidence has been obtained will be removed.
- The statement that the financial statements have been audited will be changed to the auditor was engaged to audit the financial statements.

(e) **Cleves**

- The financial statements do not contain a statement of profit or loss which is one of the primary financial statements and must be presented.
- The financial statements are misstated and the effect is pervasive.
- The audit opinion will be modified.
- An adverse opinion will be issued stating that the financial statements do not give a true and fair view.
- The basis for opinion section will be amended to a basis for adverse opinion.
- The basis for adverse opinion section will explain the reason for the adverse opinion and quantify the effect of the issue on the financial statements.

(f) **Parr**

- The claim is material and represents an uncertainty that should be communicated to the users of the financial statements.
- The directors have correctly disclosed the matter in the financial statements.
- The audit opinion will be unmodified as the financial statements give a true and fair view.
- Additional communication will be required to highlight the disclosure made by the client to the user.
- This could be achieved by including an emphasis of matter paragraph. The emphasis of matter paragraph will refer to the client's disclosure of the court case to make the users aware of it.
- Alternatively, the auditor may consider the issue a material uncertainty related to going concern and refer to the court case by including a going concern section in the report instead of an emphasis of matter.
- The choice of how the auditor should refer to the matter in the auditor's report is a matter of professional judgement.

Test your understanding 4

(a) Overall review of evidence is important as it enables the auditor to ensure:

- sufficient appropriate evidence has been obtained.
- the evidence supports the conclusions reached, and is appropriately documented.
- work has been performed in accordance with professional standards.

Review of the audit work is also important for the appraisal and development of staff.

(b) Audit procedures over equity

Share capital

- Agree authorised share capital and nominal value disclosures to underlying shareholding agreements/statutory constitution documents.
- Inspect the bank ledger account for evidence of cash receipts from share issues and ensure amounts not yet received are correctly disclosed as share capital called-up not paid in the financial statements.
- Inspect board minutes to verify the issue of new shares during the year.

Audit procedures: Reserves

- Agree opening reserves to prior-year closing reserves and reconcile movements.
- Agree movements in reserves to supporting documentation (e.g. agree revaluation surplus movements to an independent valuer's report).

(c) Impact on auditor's report:

(i) Faulty brake systems

The amount of $10m is 111% ($10m/$9m) of profit before tax and is therefore material.

The $10m provision would turn a profit of $9m into a loss of $1m and is also therefore pervasive.

It is probable that Brakes Co will lose the legal case and therefore the claim of $10m should be provided for in the financial statements in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The audit opinion will be modified as the financial statements are materially misstated.

An adverse opinion will be issued stating that the financial statements do not give a true and fair view.

The basis for opinion section will be amended to a basis for adverse opinion.

The basis for adverse opinion section will explain the reason for the adverse opinion and quantify the effect of the issue on the financial statements.

The Key Audit Matters section will reference the 'Basis for Adverse Opinion'.

(ii) Contaminated brake fluid

Inventory should be valued at the lower of cost and net **realisable value** (IAS 2 *Inventories*, 9).

The contaminated brake fluid cost $125,000. If sold at the original price charged of $137,500, the net realisable value will be $75,000 ($137,500 less $62,500 re-filtering costs). Inventory is therefore overstated by $50,000.

$50,000 is not material at 0.6% of profit ($50,000/$9m) and 0.1% of total assets ($50,000/$37m).

The misstatement should be brought to the attention of management and they should be asked to correct it. However, as the misstatement is not material, the audit opinion will not be modified in respect of this matter and no reference to the misstatement will be required in the auditor's report.

(iii) Inventory held at third party premises

The auditor has not obtained sufficient appropriate evidence over the inventory held at third party premises.

The inventory is material to the statement of profit or loss at 36% of profit ($3.2m/$9m) and the statement of financial position at 8.6% of total assets ($3.2m/$37m).

If alternative sources of evidence cannot be obtained, it will be necessary to modify the audit opinion due to an inability to obtain sufficient appropriate evidence.

A qualified opinion using the ‘except for’ wording will be necessary.

The basis for opinion section will be amended to a basis for qualified opinion.

The basis for qualified opinion section will explain the reason for the qualified opinion and quantify the effect of the issue on the financial statements.

The Key Audit Matters section will reference the 'Basis for Qualified Opinion'.

Test your understanding 5

1	D	Qualified or disclaimer. Six months of accounting records have been lost meaning sufficient appropriate evidence will not be available. Whether the matter is deemed material but not pervasive or material and pervasive will depend on the auditor's assessment of the reconstruction of figures for the first six months.
2	B	A 'basis for opinion' paragraph confirms the audit has been conducted in accordance with ISAs and ethical requirements.
3	C	Addressee, opinion, auditor's responsibilities, date.
4	C	A disclaimer of opinion is where the auditor does not express an opinion.
5	B	ISA 705 states that where a disclaimer of opinion is issued, the Key Audit Matters section should not be included in the auditor's report.

Test your understanding 6

1	A	The misstatement represents 150% of PBT and would turn the profit to a loss which is pervasive. Therefore an adverse opinion would be appropriate.
2	C	The misstatement represents 35% of PBT. This is material but not pervasive. A qualified opinion is appropriate.
3	D	The misstatement would represent 4.1% of PBT. This is not material. An unmodified opinion would be appropriate.
4	B	A section titled 'Material Uncertainty Related to Going Concern' will be included in the auditor's report.
5	B	No further reporting implications. The Key Audit Matters section should not describe matters already described in an Emphasis of Matter paragraph. The Basis for Opinion section would only describe matters giving rise to a modified opinion. As management has included the provision and disclosure of the legal case in the financial statements there is no reason to modify the audit opinion.

Chapter

13

Employability and technology skills

Chapter learning objectives

This chapter contains an overview of the employability and technology skills syllabus area. This is relevant for all ACCA Applied Skills (except LW) and Strategic Professional exams.

1 Purpose of chapter

This chapter explains the content included within the employability and technology skills syllabus area. A similar syllabus area is included in all Applied Skills (except LW) and Strategic Professional level syllabi.

ACCA exams utilise software and technology similar to those used in the modern workplace. By studying ACCA exams, candidates will be equipped with both technical syllabus knowledge and practical, applied software skills. The employability and technology skills syllabus area is included within the syllabus to acknowledge this acquired skillset.

2 Content of the employability and technology skills syllabus area

The employability and technology skills syllabus area is outlined in the syllabus and study guide. It consists of the following:

1 Use computer technology to efficiently access and manipulate relevant information.

2 Work on relevant response options, using available functions and technology, as would be required in the workplace.

3 Navigate windows and computer screens to create and amend responses to exam requirements, using the appropriate tools.

4 Present data and information effectively, using the appropriate tools.

By using a computer-based examination (CBE), the ACCA has enabled the use of word processing, spreadsheet, screen navigation and data processing functionalities to become part of their assessment range. This replicates the skills used in the modern workplace, whether in accounting practice, in industry or outside of accountancy altogether.

Whilst sitting an exam, candidates will be using the functionality of the CBE software in a variety of ways e.g. to prioritise information within the question data provided, to organise and present their answers in a manageable fashion, to use shortcuts and software functionality to increase efficiency. Skills garnered in the workplace can be used in the examination and vice versa.

This reflects that exams offered at Applied Skills and Strategic Professional are designed to be relevant and accessible to all students. The delivery mode and assessment types require students to demonstrate similar skills to those required in the modern workplace. Offering computer-based exams (CBE) at all levels gives students the opportunity to focus on the application of knowledge to scenarios, using a range of tools – spreadsheets, word processing and presentations. This not only allows students to demonstrate their technical and professional skills, but also their use of the technology relevant to the modern workplace. CBEs, therefore, offers the candidate an examination delivery method that allows them to demonstrate their knowledge and skills with the technology they are most familiar with, in the classroom or at work.

3 CBE support and the ACCA Exam Practice Platform

ACCA candidates can access the ACCA's Exam Practice Platform to practice attempting questions using the CBE software. It is imperative that candidates are familiar with the software before attempting the exam.

The link to the AA Exam Practice Platform access gateway can be found here:

https://bit.ly/39OE1Yz

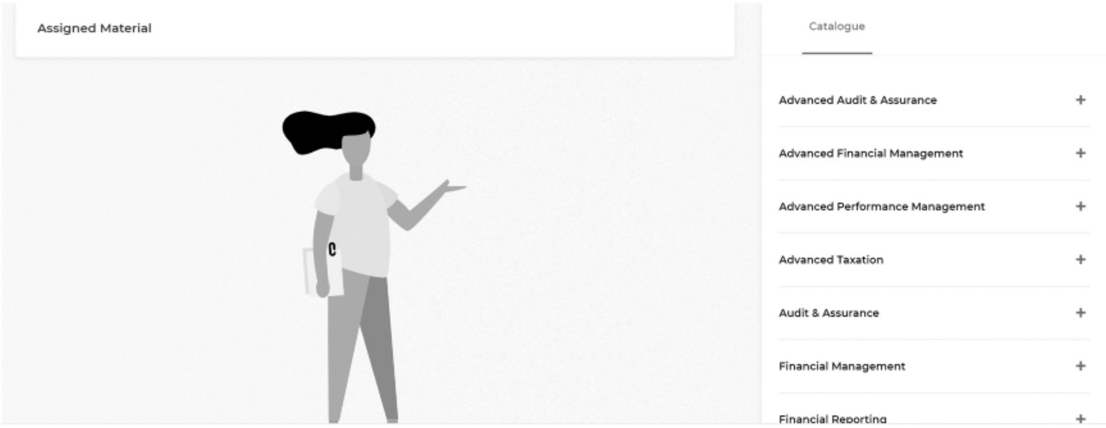
This requires a MyACCA login to access the platform.

Support, access to other subjects, tutorial videos and CBE advice can be found here:

https://www.accaglobal.com/gb/en/student/exam-support-resources.html

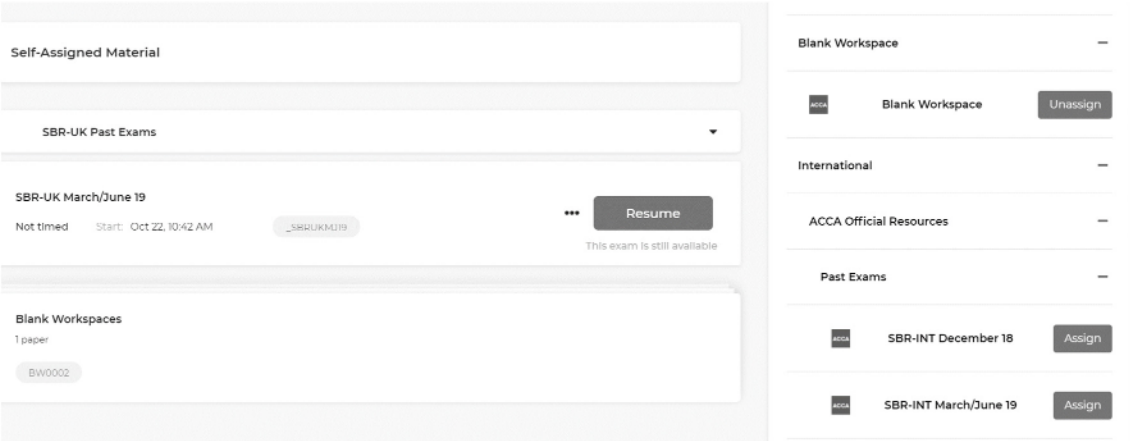
4 Contents of the CBE and Exam Practice Platform

On entering the Exam Practice Platform, candidates will access their dashboard, as follows:



Candidates should click their appropriate subject in the right-hand side menu. There they will be able to 'assign' content to their workspace. Candidates can assign a blank workspace or ACCA official resources (which include past exams presented using the CBE software for the candidates to attempt) to their workspace.

This will be added to the candidate's 'Self-Assigned Material' listing as below:



When working within the assignment the candidate will use response options to provide their answer.

The **Response Options** are where the candidate will attempt their answers.

Up to two types of response option will be provided for AA. Not every option will appear in each question.

The response options are:

– the word processor, and

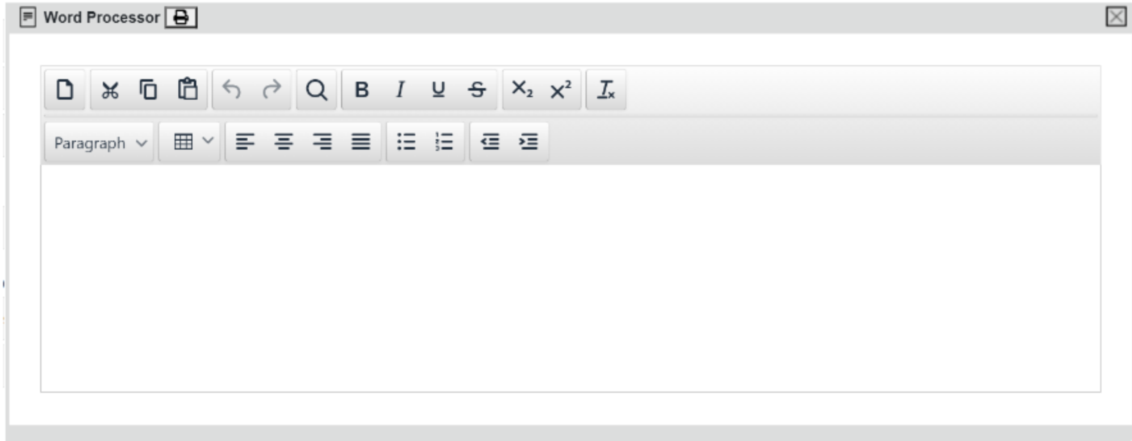
– the spreadsheet.

The candidate must determine which of the response options is the most suitable for their specific answer.

These replicate the functionality of widely used software packages. The ACCA has developed this software, for use during home question practice and under exam conditions, to replicate the practical skill sets and work-based behaviours adopted by various industries throughout the world. By studying the ACCA qualification, candidates will improve, not only on their technical knowledge and understanding, but also on skills applied on a daily basis within their work environments. Candidates should practise questions using the CBE platform to ensure they are familiar with the various functions available within their specific examination.

Word Processor

The word processor response option will appear as follows:



This resource has the following advantages and disadvantages:

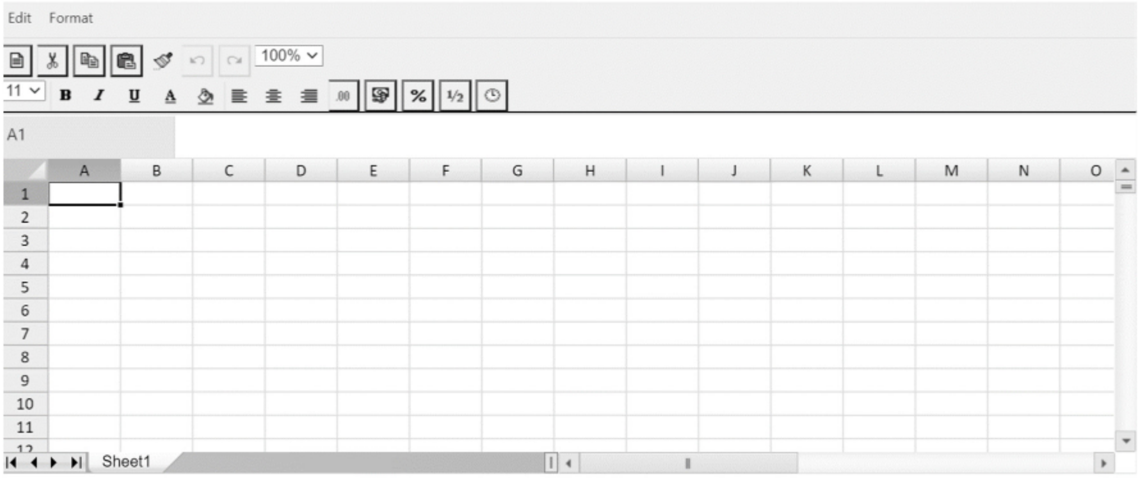
Advantages	Disadvantages
It is easier to continue typing without entering new cells or becoming concerned about cell width	It cannot automatically perform calculations
Answers can be more easily split into paragraphs to make them more visually appealing and easier to mark	Numerical tables can be difficult to label and align
Bullet points can be used to present lists	
Text can be easily aligned and justified	
Superscript and subscript can be easily added to express terms such as 4^2, for example	

It is, therefore, best suited to discursive answers where candidates are asked, for example, to discuss, analyse or evaluate issues from a scenario or calculation.

The word processing software application could be used in the workplace within the writing of meeting agendas, meeting minutes, external letters, marketing output, briefings, audit reports, textbooks and instructional documentation.

Spreadsheet

The spreadsheet response option, when relevant, will appear as follows:



The spreadsheet software uses the same functionality as other commonly used spreadsheet software. Basic formulae functionality, such as SUM, power functions (e.g. SQRT) and the use of brackets are all reproduced within the ACCA software. Candidates are advised to practise questions using the software so that they are familiar with the functions available and how they can be utilised to the candidate's advantage through improved efficiency.

This resource has the following advantages and disadvantages:

Advantages	**Disadvantages**
This can quickly and easily perform calculations (e.g. using sums for totals or formulae for calculations)	Text will carry over beyond one cell and may go across and beyond the page width making answers difficult to follow (and mark)
Data within tables can be easily aligned	Bullet points are difficult to use
Shortcut icons can be used to quickly round figures, change numbers to percentages etc.	
Tables can easily and quickly be copied when calculations need to be reperformed (e.g. for sensitivity analysis, tax calculations for more than one person, financial statements for more than one company etc.)	
Column width can be adjusted to label length	

It is, therefore, best suited for performing calculations within the examination e.g. ratio calculations.

Spreadsheet software is ubiquitous in the modern workplace. It has the capacity to record, store and organise huge swathes of data and information relating to all aspects of a business. Examples of only a few of its possible practical applications include the preparation of management and financial accounts, operational controls and record-keeping e.g. expense claims, data analytics, project appraisals, sample size selection and tax computations.

5 Chapter summary

The CBE software will replicate the work that is performed by accountants in a typical workplace. It will be used across the syllabus to support a candidate's answer by providing suitable response options for different types of answers.

These response options will be most suitable in the following instances (when available):

– For discursive answers: it is best to use the word processing option

– For calculations: it is best to use the spreadsheet option.

Chapter

14

Summary of key ISAs

Chapter learning objectives

This section is designed to help you with the key requirements of the International Auditing Standards.

200 series: General principles and responsibilities

ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

Objectives of the auditor [11]:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- To express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Responsibilities of management [A2]:

- Preparation of the financial statements in accordance with the applicable financial reporting framework, including their fair presentation.
- Internal control necessary to enable preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- To provide the auditor with:
  - Access to all information relevant to the preparation of the financial statements
  - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain evidence.

Risk:

- Audit: the risk of issuing an inappropriate opinion. [13c]
- Inherent: the susceptibility of an assertion about a class of transaction (e.g. revenue) or account balance (e.g. receivables) or disclosure to material misstatement before the consideration of any related internal controls. [13ni]
- Control: the risk that material misstatement could occur in an assertion about a class of transactions, account balance or disclosure and will not be prevented, or detected and corrected by the entity’s controls. [13nii]
- Detection: the risk that audit procedures do not detect material misstatements. [13e]

An auditor must perform the audit with professional scepticism: an attitude that includes a questioning mind, being alert to conditions which indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. [13l]

Inherent limitations of audit [A47]:

Audit evidence is persuasive rather than conclusive because of:

- The nature of financial reporting
- The nature of audit procedures
- The need to conduct audit a within reasonable time and at reasonable cost.

ISA 210 *Agreeing the Terms of Audit Engagements*

The auditor should establish whether the preconditions for an audit are present [6]:

- Determine whether an acceptable financial reporting framework is to be applied in the preparation of the financial statements; and
- Obtain agreement of management that it acknowledges and understands its responsibilities.

Contents of engagement letter [10]:

- Objective and scope of the audit.
- Responsibilities of the auditor.
- Responsibilities of management.
- Identification of the applicable financial reporting framework.
- Expected form and content of any reports to be issued.

ISA 220 (Revised) *Quality Management for an Audit of Financial Statements*

The firm should have a system of quality management to ensure [2]:

- Compliance with professional standards, and
- Reports issued are appropriate in the circumstances.

The audit engagement partner:

- Takes responsibility for managing and achieving quality on the audit engagement. The partner must be sufficiently and appropriately involved throughout the engagement to determine whether the conclusions reached are appropriate. [13]
- The audit engagement partner must emphasise that the audit team are responsible for contributing to the achievement of quality, the importance of ethics and the importance of professional scepticism. [14]

- Takes responsibility for direction and supervision of the team and review of their work. [29]
- Shall review audit documentation at appropriate points during the audit. [31]
- Takes responsibility for the firm's monitoring and remediation process. [39]

The Audit and Assurance syllabus requires an understanding of the relevant ethical requirements, engagement resources, engagement performance and monitoring and remediation areas of quality management.

Ethical requirements – identify, evaluate and address threats. [17]

Engagement resources – there must be sufficient and appropriate resources available for the audit. This includes human, technological and intellectual resources. [25]

Engagement performance – comprises direction, supervision and review of the audit.

An engagement quality review must be performed for listed and public interest entities and high risk engagements. [ISQM 1, A133, A134]

ISA 230 *Audit Documentation*

Objective of documentation [2]:

- Evidence of the basis for the independent auditor's report
- Evidence that audit planned and performed in accordance with ISAs and legal/regulatory requirements.

Audit documentation should enable an experienced independent auditor with no previous connection to the audit to understand [8]:

- Nature, timing & extent of audit procedures performed:
- Results of audit procedures performed.
- Significant conclusions and professional judgements made in reaching those conclusions.

ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Objectives of the auditor [11]:

- Identify risks of material misstatement due to fraud.
- Obtain sufficient appropriate evidence regarding assessed risks.
- Respond appropriately to fraud or suspected fraud identified.

Definition [12a]: An intentional act involving use of deception to obtain unjust/illegal advantage.

Two types of fraud [3]:

- Fraudulent financial reporting.
- Misappropriation of assets.

Audit procedures must be performed to: [33]:

- Test the appropriateness of journal entries.
- Review accounting estimates for bias.
- Identify significant transactions outside the normal course of business.

ISA 250 (Revised) *Consideration of Laws and Regulations in an Audit of Financial Statements*

Auditor’s objectives [11]:

- Obtain sufficient appropriate evidence regarding compliance with provisions of laws/regulations that may materially affect FS.
- Perform audit procedures to identify instances of non-compliance that may materially affect FS.
- Respond appropriately to identified or suspected non-compliance during the audit.

ISA 260 (Revised) ***Communication With Those Charged With Governance***

Those charged with governance are those with responsibility for overseeing the strategic direction of the entity. [10a]

Matters to be communicated:

- Auditor's responsibility in relation to the FS audit [14]
- Planned scope and timing of audit [15]
- Significant findings from audit [16]
- Auditor's independence (listed companies). [17]

ISA 265 ***Communicating Deficiencies in Internal Control to Those Charged With Governance and Management***

Reporting responsibilities:

- Significant deficiencies, to those charged with governance [9]
- Significant deficiencies and other deficiencies, to an appropriate level of management. [10]

What makes deficiencies significant [A6]:

- Likelihood of material misstatement in the FS.
- Susceptibility to loss or fraud of the related asset.
- Volume of activity in the related account balance.
- Interaction of the deficiency with other deficiencies.

300 & 400 series: Assessment and response to assessed risks

ISA 300 *Planning an Audit of Financial Statements*

Benefits of planning [2]:

- Helps the auditor to devote appropriate attention to important areas of the audit.
- Helps identify and resolve potential problems on a timely basis.
- Assists in the selection of a suitable audit team.
- Helps the direction and supervision of the audit team.
- Assists the auditor to perform an efficient and effective audit.

Content of audit strategy [8]:

- Characteristics of the engagement
- Reporting objectives (e.g. reporting timetable)
- Factors significant in directing the team's efforts
- Results of preliminary engagement activities
- Nature, timing and extent of resources.

Content of audit plan [9]:

Nature, timing and extent of:

- Planned risk assessment procedures.
- Planned further audit procedures at the assertion level.
- Other planned procedures required to comply with ISAs.

ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*

Understanding the entity and its environment, and the applicable financial reporting framework [19]:

- Organisational structure, ownership and governance, business model
- Industry, regulatory and other external factors:
- Measures used internally and externally to assess financial performance
- The applicable financial reporting framework and accounting policies
- How inherent risk factors affect susceptibility of assertions to misstatement and the extent to which they do so.

Inherent risk is affected by complexity, subjectivity, change, uncertainty and susceptibility to misstatement due to management bias. [A7]

Understanding the components of the entity's system of internal control:

- Control environment [21]
- Entity's risk assessment process [22]
- The entity's process to monitor the system of internal control [24]
- Information system and communication [25]
- Control activities. [26]

Assertions [A190]:

- Transactions and events and related disclosures: Occurrence; completeness; accuracy; cut-off; classification; presentation.
- Account balances and related disclosures: Existence; rights & obligations; completeness; accuracy, valuation & allocation; classification; presentation.

ISA 320 *Materiality in Planning and Performing an Audit*

Materiality: Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. [2]

Performance materiality: an amount set at less than materiality for the FS as a whole, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the FS as a whole. [9]

ISA 330 *The Auditor's Responses to Assessed Risks*

The auditor shall design and perform audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. [6]

Substantive procedures: to detect material misstatements at assertion level, comprising tests of details and substantive analytical procedures. [4a]

Test of controls: to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level. [4b]

If the auditor intends to rely on controls over an area of significant risk, the auditor shall test those controls in the current period. [15]

ISA 402 ***Audit Considerations Relating to an Entity Using a Service Organisation***

The auditor of the user entity must obtain an understanding of the services provided by the service organisation and their effect on the user entity's system of internal control, sufficient to provide an appropriate basis for the identification and assessment of the risks of material misstatement and perform audit procedures responsive to those risks. [7]

An understanding of the services provided by the service organisation may be obtained from the client. [9]

If sufficient understanding is not obtained from the client, the auditor should perform one or more of the following procedures [12]:

- Obtaining a type 1 or type 2 report
- Contacting the service organisation
- Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation
- Using another auditor to perform procedures and provide information about the controls.

ISA 450 ***Evaluation of Misstatements Identified During the Audit***

A misstatement is: A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. [4a]

Requirements:

- Accumulate misstatements identified during the audit. [5]
- Determine whether the audit strategy and audit plan needs to be revised. [6]
- Communicate all misstatements accumulated with the appropriate level of management on a timely basis. [8]
- Determine whether uncorrected misstatements are material. [11]
- Request a written representation that uncorrected misstatements are not material. A summary of the uncorrected misstatements shall be included in the written representation. [14]

500 series: Evidence

ISA 500 *Audit Evidence*

Characteristics:

- Sufficiency: measure of quantity, affected by quality of evidence and risk of material misstatement. [5e]
- Appropriateness: measure of quality, linked to relevance and reliability. [5b]

Relevance: linked to FS assertions. [A27]

Reliability [A31]:

- Independent evidence is more reliable than client generated.
- Internally generated evidence is more reliable when related internal controls are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.
- Documentary evidence is more reliable than oral.
- Original documents are more reliable than copies or documents transformed into electronic form.

Procedures:

- Inspection [A14]
- Observation [A17]
- External confirmation [A18]
- Recalculation [A19]
- Reperformance [A20]
- Analytical procedures [A21]
- Enquiry. [A22]

ISA 501 *Audit Evidence – Specific Considerations for Selected Items*

The auditor should obtain sufficient appropriate evidence regarding [3]:

- Existence and condition of inventory.
- Completeness of litigation and claims involving the entity.
- Presentation and disclosure of segment information.

ISA 505 *External Confirmations*

External confirmations provide more persuasive evidence as the evidence is obtained directly by the auditor from an independent source. This is important where there is a higher assessment of audit risk. [3]

Definitions:

External confirmation – audit evidence obtained by the auditor directly from a third party in paper form or by electronic or other medium. [6a]

Positive confirmation request – a request for the third party to confirm whether they agree or disagree with the information in the request, or provide the requested information. [6b]

Negative confirmation request – a request for the third party to respond directly to the auditor only if they disagree with the information provided in the request. [6c]

ISA 520 *Analytical Procedures*

Definition: Evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. [4]

May be used as a substantive procedure. [5]

Must be used at the completion stage when forming an overall conclusion to ensure the financial statements are consistent with the auditor's understanding of the entity. [6]

ISA 530 *Audit Sampling*

Definitions:

- Audit sampling: The application of audit procedures to less than 100% of items within a population to provide the auditor with a reasonable basis to draw conclusions on entire population. [5a]
- Sampling risk: The risk the auditor's conclusion based on the sample may be different from the conclusion if the entire population were subjected to the same audit procedure. [5c]
- Non-sampling risk: The risk the auditor reaches an erroneous conclusion for any reason not related to sampling risk. [5d]
- Statistical sampling: random selection of the sample and the use of probability theory to evaluate results. [5g]
- Tolerable misstatement: A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. [5i]

Factors affecting sample sizes for substantive procedures [Appendix 3]:

- The higher the assessed risk of material misstatement, the larger the sample size.
- The more the auditor is relying on other procedures, the smaller the sample size.
- The greater the level of assurance the auditor requires, the larger the sample size.
- The lower the tolerable misstatement, the larger the sample size.
- The greater the amount of misstatement the auditor expects to find, the larger the sample size.
- When a population can be appropriately stratified, the aggregate of the sample sizes will be less than the sample size if one sample had been tested from the whole population.
- For large populations, the size of the population has little effect on the sample size.

ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*

Obtain sufficient and appropriate evidence about whether accounting estimates and related disclosures are reasonable in the context of the financial reporting framework. [11]

Audit procedures required will vary in relation to the estimation uncertainty. [3]

Professional scepticism should be increased in relation to the assessed level of inherent risk, and where accounting estimates are subject to a greater degree of estimation uncertainty. [8]

The auditor is required to:

- Separately assess inherent risk and control risk to assess the risk of material misstatement. [16]
- Respond to the risk of material misstatement by [18]:
  - Reviewing events after the reporting period
  - Testing how management made the estimate
  - Developing an independent estimate
- Request written representation from management about whether the methods, significant assumptions and data using in making the estimates are appropriate. [37]

ISA 560 *Subsequent Events*

Obtain sufficient appropriate evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of or disclosure in the financial statements are appropriately reflected in those financial statements. [4]

Between the date of the financial statements and the date of the auditor’s report, perform procedures to identify events that require adjustment or disclosure in the financial statements. [6]

No obligation to perform audit procedures after the date of the auditor’s report. If a fact becomes known that would cause the auditor to amend the auditor’s report, discuss the matter with management and determine whether the financial statements need amendment. [10]

If amendment is required and management do not amend the financial statements and then issue the financial statements, the auditor must take action to prevent reliance on the auditor’s report. [13b]

ISA 570 (Revised) *Going Concern*

Auditor must [9]:

- Obtain sufficient appropriate evidence regarding the appropriateness of management's use of the going concern basis of accounting.
- Conclude whether a material uncertainty exists about the entity's ability to continue as a going concern.
- Report in accordance with ISA 570.

ISA 580 *Written Representations*

Definition: A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. [7]

Contents:

- Management responsibility for preparation of FS. [10]
- Completeness of information provided to the auditor. [11a]
- All transactions recorded in FS. [11b]
- Plans that may affect the carrying value of the assets. [A10]
- As required by other ISAs e.g. ISA 240, 250, 450, 560, 570, 580. [Appendix 1]

600 series: Using the work of others

ISA 610 *Using the Work of Internal Auditors*

Evaluating the internal audit function [15]:

- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors.
- The level of competence of the internal audit function.
- Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Evaluating the internal audit work [23]:

- The work was properly planned, performed, supervised, reviewed and documented.
- Sufficient appropriate evidence has been obtained.
- The conclusions reached are appropriate in the circumstances.
- The reports prepared are consistent with the work performed.

Using internal audit to provide direct assistance

The external auditor may use the internal audit function to provide direct assistance with the external audit under the supervision and review of the external auditor.

- Direct assistance cannot be provided in countries where national law prohibits such assistance. [26]
- Internal auditor must be objective and competent. [27]
- External auditor must not assign work which is judgemental, a high risk of material misstatement or with which the internal auditor has been involved. [30]
- External auditor must not use the internal auditor excessively. [31]
- Management must agree not to intervene with the work. [33a]
- Internal auditor must observe confidentiality. [33b]

ISA 620 *Using the Work of an Auditor's Expert*

The auditor must:

- Evaluate the competence, capability and objectivity of the expert. [9]
- Obtain an understanding of the field of expertise. [10]
- Agree in writing the work to be performed. [11]
- Evaluate the adequacy of the expert's work for audit purposes. [12]

700 series: Audit conclusions and reporting

ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*

Content of an independent auditor's report:

- Title: [21]
  - reference to independent auditor
- Addressee: [22]
  - shareholders/members
- Auditor's Opinion: [23]
  - Identifies the entity, subject matter and reporting date [24]
  - FS give true and fair view in accordance with the applicable FR framework [25b]
- Basis for Opinion: [28]
  - Audit conducted in accordance with ISAs and ethical requirements
  - States whether the auditor believes that the audit evidence obtained is sufficient and appropriate for forming an opinion
- Going Concern: [29]
  - Reference to any going concern disclosures made by management
- Key Audit Matters (listed companies) [30]
- Other Information [32]
- Responsibilities of Management for the Financial Statements: [34]
  - Preparation of FS
  - Internal controls
  - Assessing the entity's ability to continue as a going concern
- Auditor's Responsibilities for the Audit of the Financial Statements: [38]
  - The objectives of the auditor are to obtain reasonable assurance about the FS and issue an auditor's report containing an opinion
- Name of Engagement Partner (listed entities) [46]
- Signature of the Auditor [47]
- Auditor's address [48]
- Date of the Auditor's Report [49]

ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*

Key audit matters (KAM) are those that in the auditor's professional judgement were of most significance in the audit and are selected from matters communicated with those charged with governance. [8]

KAM include: [9]

- Areas of higher assessed risk of material misstatement
- Significant auditor judgements relating to areas of significant management judgement
- Significant events of transactions that occurred during the period.

The description of each KAM will address: [13]

- Why it is considered a key audit matter
- How the matter was addressed in the audit.

ISA 705 (Revised) *Modifications to the Audit Opinion in the Independent Auditor's Report*

Definitions:

- Modified opinion: qualified, adverse or disclaimer of opinion [5b]
- Pervasive: not confined to specific elements or representing a substantial proportion of a single element [5a]

Modifications:

- FS as a whole not free from material misstatement [6a]
  - Material but not pervasive: qualified [7a]
  - Material and pervasive: adverse [8]
- Unable to obtain sufficient appropriate evidence [6b]
  - Material but not pervasive: qualified [7b]
  - Material and pervasive: disclaimer [9]

When the auditor modifies the opinion, the basis for opinion is amended to ‘Basis for Qualified Opinion’, ‘Basis for Adverse Opinion’ or ‘Basis for Disclaimer of Opinion’ as appropriate. [20a]

The ‘Basis for...’ section includes a description of the matter giving rise to the modification. [20b]

ISA 706 (Revised) ***Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report***

Emphasis of matter

- Refers to matters appropriately presented or disclosed that are fundamental to the user's understanding of the FS. [7a]

Other matter

- Refers to matters relevant to the user's understanding of the audit, the auditor's responsibilities or the auditor's report. [7b]

ISA 720 (Revised) ***The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements***

Auditor responsibilities:

- Read other information to identify material inconsistencies with the FS or the auditor's knowledge which indicates material misstatement of the FS or the other information. [3]
- If an inconsistency is identified:
  – Perform procedures to conclude whether it is the financial statements or the other information that requires amendment. [16]
  – If other information is wrong, ask management to correct it. [17]
  – If the matter remains uncorrected, describe the inconsistency in the Other Information section of the auditor's report or withdraw from the engagement where withdrawal is possible. [18]

Chapter

15

Financial reporting revision

Chapter learning objectives

This section is designed to help you with the key requirements of the accounting standards examinable for this exam.

This chapter outlines the main requirements of the accounting standards examined in Financial Accounting at the Applied Knowledge level which are examinable for Audit & Assurance.

IAS 1 Presentation of Financial Statements

This standard provides formats for the statement of profit or loss and other comprehensive income, statement of financial position, and statement of changes in equity.

Accounting policies should be selected so that the financial statements comply with all international standards and interpretations.

Other comprehensive income should be presented in two categories, namely items that:

- will not be reclassified to profit or loss, and
- may be reclassified to profit or loss in future reporting periods.

IAS 2 Inventories

Inventories should be valued 'at the lower of cost and net realisable value' (IAS 2, para 9).

The cost of inventory includes:

- Purchase price including import duties, transport and handling costs
- Direct production costs e.g. direct labour
- Direct expenses and subcontracted work
- Production overheads (based on the normal levels of activity)
- Other overheads, if attributable to bringing the product or service to its present location and condition.

Cost excludes:

- Abnormal waste
- Storage costs
- Indirect administrative overheads
- Selling costs.

Some entities can identify individual units of inventory (e.g. vehicles can be identified by a chassis number). Those that cannot should keep track of costs using either the first in, first out (FIFO) or the weighted average cost (AVCO) assumption.

Some entities may use standard costing for valuing inventory. Standard costs may be used for convenience if it is a close approximation to actual cost, and is regularly reviewed and revised.

IAS 7 Statement of Cash Flows

Requires a statement of cash flow that shows cash flows generated from:

- Operating activities
- Investing activities
- Financing activities.

IAS 10 Events After the Reporting Period

Definitions

Events after the reporting period are **'those events, favourable and unfavourable, that occur between the statement of financial position date and the date when the financial statements are authorised for issue'** (IAS 10, para 3).

Adjusting events after the reporting period are those that 'provide evidence of conditions that existed at the reporting date' (IAS 10, para 3a).

Non-adjusting events after the reporting period are **'those that are indicative of conditions that arose after the reporting period'** (IAS 10, para 3b).

Accounting treatment

Adjusting events affect the amounts stated in the financial statements so they must be adjusted.

Non-adjusting events do not concern the position as at the reporting date so the financial statements are not adjusted. If the event is material then the nature and its financial effect must be disclosed.

IAS 16 Property, Plant and Equipment

Cost of an asset

Property, plant and equipment is initially recognised at cost.

An asset's cost is its purchase price, less any trade discounts or rebates, plus any further costs directly attributable to bringing it into working condition for its intended use.

Subsequent expenditure on non-current assets is capitalised if it:

- Enhances the economic benefits of the asset e.g. adding a new wing to a building.
- Replaces part of an asset that has been separately depreciated and has been fully depreciated; e.g. a furnace that requires new linings periodically.
- Replaces economic benefits previously consumed, e.g. a major inspection of aircraft.

Depreciation

The aim of depreciation is to spread the cost of the asset over its life in the business.

- The depreciation method and useful life of an asset should be reviewed at the end of each year and revised where necessary. This is not a change in accounting policy, but a change of accounting estimate.
- If an asset has parts with different lives, (e.g. a building with a flat roof), the component parts should be capitalised and depreciated separately.

Revaluation of property, plant and equipment

Revaluation of PPE is optional. If one asset is revalued, all assets in that class must be revalued.

Valuations should be kept up to date to ensure that the carrying amount does not differ materially from the fair value at each statement of financial position date.

Revaluation gains are credited to **other comprehensive income** unless the gain reverses a previous revaluation loss of the same asset previously recognised in the statement of profit or loss.

Revaluation losses are debited to the statement of profit or loss unless the loss relates to a previous revaluation surplus, in which case the decrease should be debited to other comprehensive income to the extent of any credit balance existing in the revaluation surplus relating to that asset.

Depreciation is charged on the revalued amount less residual value (if any) over the **remaining useful life** of the asset.

An entity may choose to make an annual transfer of excess depreciation from revaluation ssurplus to retained earnings. If this is done, it should be applied consistently each year.

IAS 27 Separate Financial Statements

This standard applies when an entity has interests in subsidiaries, joint ventures or associates and either elects to, or is required to, prepare separate **non-consolidated financial statements**.

If separate financial statements are produced, investments in subsidiaries, associates or joint ventures can be measured:

- at cost
- using the equity method
- in accordance with IFRS® 9 *Financial Instruments*.

IAS 28 Investments in Associates and Joint Ventures

Joint ventures

A joint venture is a **'joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement'** (IAS 28, para 3). This will normally be established in the form of a separate entity to conduct the joint venture activities.

Associates

An associate is defined as an entity **'over which the investor has significant influence'** (IAS 28, para 3).

Significant influence is the **'power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies'** (IAS 28, para 3).

It is normally assumed that significant influence exists if the holding company has a shareholding of 20% to 50%.

Equity accounting

In the consolidated financial statements of a group, an investment in an associate or joint venture is accounted for using the equity method.

The **consolidated statement of profit or loss** will show a single figure in respect of the associate or joint venture. This is calculated as the investor’s share of the associate or joint venture's profit for the period.

In the **consolidated statement of financial position**, the ‘investment in the associate/joint venture’ is presented in non-current assets. It is calculated as the initial cost of the investment plus/(minus) the investor's share of the post-acquisition reserve increase/(decrease).

The associate or joint venture is outside the group. Therefore transactions and balances between group companies and the associate or joint venture are not eliminated from the consolidated financial statements.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

- A provision is **'a liability of uncertain timing or amount**' (IAS 37, para 10).
- A contingent liability is a possible obligation arising from past events whose existence will only be confirmed by an uncertain future event outside of the entity's control.
- A contingent asset is a possible asset that arises from past events and whose existence will only be confirmed by an uncertain future event outside of the entity’s control.

Provisions

Provisions should be recognised when:

- An entity has a present obligation (legal or constructive) as a result of a past event
- It is probable that an outflow of economic benefits will be required to settle the obligation, and
- A reliable estimate can be made of the amount of the obligation.

Measurement of provisions:

- The provision amount should be the best estimate of the expenditure required to settle the present obligation.
- Where the time value of money is material, the provision should be discounted to present value.

Restructuring provisions:

- Provisions can only be recognised where an entity has a constructive obligation to carry out the restructuring.
- A constructive obligation arises when there is a detailed formal plan which identifies:
  - The business concerned
  - The principal location, function and approximate number of employees being made redundant
  - The expenditures that will be incurred
  - When the plan will be implemented
  - There is a valid expectation that the plan will be carried out by either implementing the plan or announcing it to those affected.

Specific guidance:

- Future operating losses should not be recognised.
- Onerous contracts should be recognised for the present obligation under the contract.

Contingent liabilities should not be recognised. They should be disclosed unless the possibility of a transfer of economic benefits is remote.

Contingent assets should not be recognised. If the possibility of an inflow of economic benefits is probable they should be disclosed.

IAS 38 Intangible Assets

An intangible asset is **'an identifiable non-monetary asset without physical substance'** (IAS 38, para 8).

Initial recognition

An intangible asset is initially recognised at cost if all of the following criteria are met.

1. It is identifiable – it could be disposed of without disposing of the business at the same time.
2. It is controlled by the entity – the entity has the power to obtain economic benefits from it, for example patents and copyrights give legal rights to future economic benefits.
3. It will generate probable future economic benefits for the entity – this could be by a reduction in costs or increasing revenues.
4. The cost can be measured reliably.

If an intangible does not meet the recognition criteria, then it should be charged to the statement of profit or loss as expenditure is incurred.

Items that do not meet the criteria are internally generated goodwill, brands, mastheads, publishing titles, customer lists, research, advertising, start-up costs and training.

Subsequent treatment

Intangible assets should be amortised over their useful lives.

If it can be demonstrated that the useful life is indefinite, no amortisation should be charged but an annual impairment review must be carried out.

Intangible assets can be revalued but fair values must be determined with reference to an active market. Active markets have homogenous products, willing buyers and sellers at all times and published prices. In practical terms, most intangible assets are likely to be valued using the cost model.

Research and development

The recognition of internally generated intangible assets is split into a research phase and a development phase.

Costs incurred in the research phase must be charged to the statement of profit or loss as they are incurred.

Costs incurred in the development phase should be recognised as an intangible asset if they meet the following criteria:

(a) The project is technically feasible

(b) The asset will be completed then used or sold

(c) The entity is able to use or sell the asset

(d) The asset will generate future economic benefits (either because of internal use or because there is a market for it)

(e) The entity has adequate technical, financial and other resources to complete the project

(f) The expenditure on the project can be reliably measured.

Amortisation of development costs will occur over the period that benefits are expected.

IFRS 3 Business Combinations

On acquisition of a subsidiary, the purchase consideration transferred and the identifiable net assets acquired are recorded at fair value.

Fair value is **'the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date'** (IFRS 13, para 9).

Purchase consideration

Purchase consideration is measured at fair value. Note that:

- Deferred cash consideration should be discounted to present value using a rate at which the acquirer could obtain similar borrowing.
- The fair value of the acquirer's own shares is the market price at the acquisition date.
- Contingent consideration is included as part of the consideration at its fair value, even if payment is not probable.

Goodwill and the non-controlling interest

The non-controlling interest (NCI) at acquisition is measured at either:

- Fair value, or
- The NCI's proportionate share of the fair value of the subsidiary's identifiable net assets.

Gain on bargain purchase

If the net assets acquired exceed the fair value of consideration, then a gain on bargain purchase (negative goodwill) arises.

After checking that the calculations have been done correctly, the gain on bargain purchase is credited to profit or loss.

Other adjustments

Other consolidation adjustments need to be made in order to present the parent and its subsidiaries as a single economic entity. Transactions that require adjustments include:

- Interest on intragroup loans
- Intragroup management charges
- Intragroup sales, purchases and unrealised profit in inventory
- Intragroup transfer of non-current assets and unrealised profit on transfer
- Intragroup receivables, payables and loans.

IFRS 10 Consolidated Financial Statements

Consolidated financial statements must be prepared if one company controls another company.

Control consists of three components:

1. **Power** over the investee: this is normally exercised through the **majority of voting rights**, but could also arise through other contractual arrangements.
2. **Exposure** or rights to variable returns (positive and/or negative), and
3. The **ability to use power** to affect the investor's returns.

It is normally assumed that control exists when one company owns more than half of the ordinary shares in another company.

IFRS 15 Revenue from Contracts with Customers

Revenue recognition is a five step process.

1 **Identify the contract**

A contract is an agreement between two or more parties that creates rights and obligations.

2 **Identify the separate performance obligations within a contract**

Performance obligations are, essentially, promises made to a customer.

3 **Determine the transaction price**

The transaction price is the amount the entity expects to be entitled in exchange for satisfying all performance obligations. Amounts collected on behalf of third parties (such as sales tax) are excluded.

4 **Allocate the transaction price to the performance obligations in the contract**

The total transaction price should be allocated to each performance obligation in proportion to stand-alone selling prices.

5 **Recognise revenue when (or as) a performance obligation is satisfied**

For each performance obligation an entity must determine whether it satisfies the performance obligation over time or at a point in time.

An entity satisfies a performance obligation over time if one of the following criteria is met:

(a) **'the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs**

(b) **the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or**

(c) **the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date'** (IFRS 15, para 35).

For a performance obligation satisfied over time, an entity recognises revenue based on progress towards satisfaction of that performance obligation.

If a performance obligation is not satisfied over time then it is satisfied at a point in time. The entity must determine the point in time at which a customer obtains control of the promised asset.

Chapter

16

Questions and Answers

Test your understanding 1 – Confidentiality

Client confidentiality underpins the relationship between Chartered Certified Accountants in practice and their clients. It is a core element of ACCA's Code of Ethics and Conduct.

Required:

(a) **Explain the circumstances in which external auditors are permitted or required to disclose information relating to their clients to third parties without the knowledge or consent of the client.**

(4 marks)

(b) A waste disposal company has breached tax regulations, environmental regulations and health and safety regulations. The auditor has been approached by the tax authorities, the government body supervising the award of licences to such companies and a trade union representative. All of them have asked the auditor to provide them with information about the company. The auditor has also been approached by the police. They are investigating a suspected fraud perpetrated by the managing director of the company and they wish to ask the auditor certain questions about him.

Describe how the auditor should respond to these types of request.

(6 marks)

(Total: 10 marks)

Test your understanding 2 – Ethical threats

You are a manager in the audit firm of JT & Co and this is your first time you have worked on one of the firm's established clients, Pink Co. The main activity of Pink Co is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Pink Co is a listed company regulated by the relevant financial services authority.

You have been asked to start the audit planning for Pink Co, by Mrs Goodall, a partner in JT & Co. Mrs Goodall has been the engagement partner for Pink Co, for the previous seven years and so has a sound knowledge of the client. Mrs Goodall's son, Simon, would like to be part of the audit team this year. Simon has recently started studying the ACCA qualification. Mrs Goodall also informs you that the audit senior, received investment advice from Pink Co during the year and intends to do the same next year.

In an initial meeting with the finance director of Pink Co, you learn that the audit team will not be entertained on Pink Co's yacht this year as this could appear to be an attempt to influence the audit opinion. Instead, the audit team has been invited to a day at the horse races costing less than two fifths of the expense of using the yacht.

JT & Co has done some consulting work previously and the invoice is still outstanding.

Required:

Identify and explain FIVE threats to independence in relation to the audit of Pink Co by JT & Co. For each threat, recommend how the threat can be managed.

Prepare your answer using two columns headed Ethical threat and Possible safeguard respectively.

(10 marks)

Test your understanding 3 – Analytical risk assessment

(a) With reference to ISA 520 *Analytical Procedures* explain:

(i) what is meant by the term 'analytical procedures'

(1 mark)

(ii) the different types of analytical procedures available to the auditor

(3 marks)

(iii) the situations in the audit when analytical procedures are used.

(3 marks)

It is 1 July 20X5. You are an audit senior in Quest & Co and you are planning the audit of Tribe Co for the year ending 31 July 20X5. Tribe Co sells bathrooms from 15 retail outlets. Sales are made to individuals, with income being in the form of cash and debit cards. All items purchased are delivered to the customer using Tribe Co's own delivery vans as most bathrooms are too big for individuals to transport in their own motor vehicles. The directors of Tribe Co indicate that the company has had a difficult year, but are pleased to present some acceptable results to the members.

The statement of profit or loss for the last two financial years are shown below:

Statement of profit or loss

	31 July 20X5	31 July 20X4
	$000	$000
Revenue	11,223	9,546
Cost of sales	(5,280)	(6,380)
	5,943	3,166
Operating expenses		
Administration	(1,853)	(1,980)
Selling and distribution	(1,472)	(1,034)
Interest payable	(152)	(158)
Investment income	218	–
Profit before tax	2,684	(6)

Statement of financial position extract

Cash and bank	380	(1,425)

Required:

(b) As part of your risk assessment procedures for Tribe Co, identify and provide a possible explanation for unusual changes in the statement of profit or loss.

(8 marks)

(Total: 15 marks)

Test your understanding 4 – Audit risk

It is 1 July 20X5. You are an audit senior in Staple and Co and you are commencing the planning of the audit of Smoothbrush Paints Co (Smoothbrush) for the year ending 31 August 20X5. Smoothbrush is a paint manufacturer and has been trading for over 50 years. It operates from one central site which includes the production facility, warehouse and administration offices.

Smoothbrush sells all of its goods to large home improvement stores, with 60% being to one large chain store Homewares. The company has a one-year contract to be the sole supplier of paint to Homewares. It secured the contract through significantly reducing prices and offering a four-month credit period, the company's normal credit period is one month.

Goods in/purchases

In recent years, Smoothbrush has reduced the level of goods directly manufactured and instead started to import paint from South Asia. Approximately 60% is imported and 40% manufactured. Within the production facility is a large amount of old plant and equipment that is now redundant and has minimal scrap value. Purchase orders for overseas paint are made six months in advance and goods can be in transit for up to two months. Smoothbrush accounts for the inventory when it receives the goods.

To avoid the disruption of a year-end inventory count, Smoothbrush has this year introduced a continuous/perpetual inventory counting system. The warehouse has been divided into 12 areas and these are each to be counted once over the year. At the year end it is proposed that the inventory will be based on the underlying records. Traditionally Smoothbrush has maintained an inventory allowance based on 1% of the inventory value, but management feels that as inventory is being reviewed more regularly it no longer needs this allowance.

Finance Director

In May 20X5 Smoothbrush had a dispute with its finance director (FD) who immediately left the company. The directors have temporarily asked the financial controller to take over the role while they recruit a permanent replacement. The former FD has notified Smoothbrush of intention to sue for unfair dismissal. The directors are not proposing to make any provision or disclosure for this, as they are confident the claim has no merit.

Required:

(a) Explain EIGHT audit risks identified at the planning stage of the audit of Smoothbrush Paints Co.

(8 marks)

(b) Discuss the importance of assessing risks at the planning stage of an audit.

(6 marks)

(c) Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the valuation of Smoothbrush Paints Co's inventory.

(3 marks)

(d) Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the completeness of Smoothbrush Paints Co's provisions or contingent liabilities.

(3 marks)

(Total: 20 marks)

Test your understanding 5 – Fraud

Fraud and error present risks to an entity. Both internal and external auditors are required to deal with risks to the entity. However, the responsibilities of internal and external auditors in relation to the risk of fraud and error differ.

Required:

(a) **Explain how the internal audit function helps an entity deal with the risk of fraud and error.**

(5 marks)

(b) **Explain the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements.**

(5 marks)

(c) Stone Holidays is an independent travel agency. It takes commission on holidays sold to customers through its chain of high street shops. Staff are partly paid on a commission basis. Well-established tour operators run the holidays that Stone Holidays sells. The networked reservations system through which holidays are booked, and the computerised accounting system, are both well-established systems used by many independent travel agencies.

Payments by customers, including deposits, are accepted in cash and by debit and credit card. Stone Holidays is legally required to pay an amount of money (based on its total sales for the year) into a central fund maintained to compensate customers if the agency should cease operations.

Describe the nature of the risks to which Stone Holidays is subject arising from fraud and error.

(5 marks)

(Total: 15 marks)

Test your understanding 6 – Quality management

You are the partner responsible for quality management within your firm. You are reviewing the findings from a recent post-issuance (cold) review performed by your firm's compliance department. The following issues were identified.

Client A

Some working papers had not been signed off by the team member who completed the work. Some working papers were not dated and some did not have a signature confirming they had been reviewed.

Client B

A mandatory procedure included in the audit plan which required a written representation letter to be obtained, had not been completed. A comment had been added by the audit manager stating that there were no issues requiring a written representation from management.

Client C

An audit test over purchases required a sample of 30 invoices to be tested. 27 had been tested and found to be recorded accurately and completely. Three invoices could not be found. No further invoices were identified for testing and a conclusion was drawn based on the 27 items tested.

Client D

The audit of a material provision was performed by the audit junior as the audit manager was too busy finishing off work for the previous audit client on which they had been working.

Client E

The planning section of the file has not been completed. The audit procedures performed were copied over from the previous year's file and the same approach and sample sizes have been used for this year's audit.

Required:

Describe the quality management issues arising from each of the findings.

(10 marks)

Test your understanding 7 – Controls

You are carrying out the audit of the purchases system of Spondon Furniture. The company has revenue of $10 million and all the shares are owned by Mr and Mrs Fisher, who are non-executive directors and are not involved in the day-to-day running of the company.

The bookkeeper maintains all the accounting records and prepares the annual financial statements.

The company uses a standard computerised accounting package.

You have determined that the purchases system operates as follows:

- When materials are required for production, the production manager sends a handwritten note to the buying manager. For orders of other items, the department manager or managing director sends handwritten notes to the buying manager. The buying manager finds a suitable supplier and raises a purchase order. The purchase order is signed by the managing director. Purchase orders are not issued for all goods and services received by the company.
- Materials for production are received by the goods received department, who issue a goods received note (GRN), and send a copy to the bookkeeper. There is no system for recording receipt of other goods and services.
- The bookkeeper receives the purchase invoice and matches it with the goods received note and purchase order (if available). The managing director authorises the invoice for posting to the ledger.
- The bookkeeper analyses the invoice into relevant general ledger account codes and then posts it.
- At the end of each month, the bookkeeper prepares a list of suppliers to be paid. This is approved by the managing director.
- The bookkeeper prepares the cheques and remittances and posts the cheques to the list of individual supplier balances and bank ledger account/cash book.
- The managing director signs the cheques and the bookkeeper sends the cheques and remittances to the suppliers.

Mr and Mrs Fisher are aware that there may be deficiencies in the above system and have asked for advice.

Identify and explain FIVE control deficiencies in Spondon's purchases system and suggest improvements to overcome the deficiencies. (10 marks)

Test your understanding 8 – Inventory count

DinZee Co assembles fridges, microwaves, washing machines and other similar domestic appliances from parts procured from a large number of suppliers. As part of the interim audit work two weeks prior to the company's year end, you are testing the procurement and purchases systems and attending the inventory count.

On the day of the inventory count, you attended depot nine at DinZee Co. You observed the following activities:

Pre-numbered count sheets were being issued to client staff carrying out the count. The count sheets showed the inventory balances from the inventory system for checking against physical inventory.

All count staff were drawn from the inventory warehouse and were counting in teams of two.

Three counting teams were allocated to each area of the stores to count. The teams were allowed to decide which pair of staff counted which inventory within each area. Staff were warned that they had to remember which inventory had been counted.

Information was recorded on the count sheets in pencil so amendments could be made easily as required.

Any inventory not located on the pre-numbered inventory sheets was recorded on separate inventory sheets which were numbered by staff as they were used.

At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked. The sheets were not signed.

Required:

(a) Describe FOUR procedures that an auditor will normally perform prior to attending the client's premises on the day of the inventory count.

(4 marks)

(b) Identify and explain SIX deficiencies in the control system for counting inventory, and state how each deficiency can be overcome.

(12 marks)

(c) State the aim of a test of control and the aim of a substantive procedure and in respect of your attendance at DinZee Co's inventory count, state one test of control and one substantive procedure that you should perform.

(4 marks)

(Total: 20 marks)

Test your understanding 9 – Evidence and procedures

You are the auditor of BearsWorld, a company which manufactures and sells small cuddly toys by mail order. The company is managed by Azariah, although due to other business commitments Azariah only visits the office once a week. BearsWorld employs two assistants. One assistant maintains the detailed list of individual suppliers, orders inventory and pays suppliers. The other assistant receives customer orders and despatches cuddly toys. Azariah authorises important transactions such as wages and large orders.

At any time, about 100 different types of cuddly toys are available for sale. All sales are paid for at the time of ordering. Customers pay using credit cards and occasionally by sending cash. Revenue is over $5.2 million.

You are planning the audit of BearsWorld and are considering using some of the procedures for gathering audit evidence recommended by ISA 500 *Audit Evidence* as follows:

- Analytical procedures
- Inquiry
- Inspection
- Observation
- Recalculation.

Required:

For each of the above procedures in relation to the audit of Bearsworld:

(i) Explain its use in gathering audit evidence.

(ii) Describe one example how it could be used.

(iii) Explain the benefits of each procedure.

(iv) Explain the limitations of each procedure.

(20 marks)

Test your understanding 10 – Procedures

(i) Describe FIVE types of procedures for obtaining audit evidence; and

(ii) For each type of procedure, describe an example relevant to the audit of BANK balances.

Note: The total marks will be split equally between each part.

(10 marks)

Test your understanding 11 – Audit risk NFP

(a) Explain the term 'audit risk' and the three elements of risk that contribute to total audit risk.

(4 marks)

The EuKaRe charity was established in 1960. The charity's aim is to provide support to children from disadvantaged backgrounds who wish to take part in sports such as tennis, badminton and football.

EuKaRe has a detailed constitution which explains how the charity's income can be spent. The constitution also notes that administration expenditure cannot exceed 10% of income in any year.

The charity's income is derived wholly from voluntary donations. Sources of donations include:

- Cash collected by volunteers asking the public for donations in shopping areas.
- Cheques sent to the charity's head office.
- Donations from generous individuals. Some of these donations have specific clauses attached to them indicating that the initial amount donated (capital) cannot be spent and that the income (interest) from the donation must be spent on specific activities, for example, provision of sports equipment.

The rules regarding the taxation of charities in the country EuKaRe is based are complicated, with only certain expenditure being allowable for taxation purposes and donations of capital being treated as income in some situations.

Required:

(b) Describe SIX audit risks and explain the auditor's response to each risk in planning the audit of EuKaRe.

(12 marks)

(c) Explain why the control environment may be weak at the charity EuKaRe.

(4 marks)

(Total: 20 marks)

Test your understanding 12 – NFP audit

Ajio is a charity whose constitution requires that it raises funds for educational projects. These projects seek to educate children and support teachers in certain countries. Charities in the country in which Ajio operates have recently become subject to new audit and accounting regulations. Charity income consists of cash collections at fundraising events, telephone appeals, and money left to the charity by deceased persons. The charity is small and the trustees do not consider that the charity can afford to employ a qualified accountant. The charity employs a part-time bookkeeper and relies on volunteers for fundraising. Your firm has been appointed as accountants and auditors to this charity. Accounts have been prepared in the past by a volunteer who is a recently retired Chartered Certified Accountant but these accounts have not been audited.

Required:

(a) Explain the audit risks associated with the audit of Ajio.

(4 marks)

(b) Describe the audit procedures to be performed on income and expenditure from fund raising events.

(6 marks)

Note: You are not required to deal with the detail of accounting for charities in either part of the question.

(Total: 10 marks)

Test your understanding 13 – Subsequent events

It is 1 July 20X5. You are working on the audit of Grains 4U Co (Grains), a manufacturer of breakfast cereals which has three factories, four warehouses and three distribution depots spread across North America. The audit for the year ended 31 March 20X5 is almost complete and the financial statements and auditor's report are due to be signed shortly. Profit before tax is $7.9 million. The following events have occurred subsequent to the year end and no amendments or disclosures have been made in the financial statements.

Event 1 – Fire

On 15 May 20X5, a fire occurred at the largest of the distribution depots. The fire resulted in extensive damage to 40% of the company's vehicles used for dispatching goods to customers, however, there have been no significant delays to customer deliveries. The company estimates the level of damage to the vehicles to be in excess of $650,000. Only a minimal level of inventory, approximately $25,000, was damaged. Grain's insurance company has started to investigate the fire to assess the likelihood and level of payment, however, there are concerns the fire was started deliberately, and if true, would invalidate any insurance cover.

Event 2 – Inventory

On 18 May 20X5, it was discovered that a large batch of Grain's new cereal brand 'Loopy Green Loops' held in inventory at the year end was defective, as the cereal contained too much green food colouring. To date no sales of this new cereal have been made. The cost of the defective batch of inventory is $915,000 and the defects cannot be corrected. However, the scrapped cereal can be utilised as a raw material for an alternative cereal brand at a value of $50,000.

Required:

For each of the two subsequent events described above:

(i) Based on the information provided, explain whether the financial statements require amendment, and

(ii) Describe audit procedures which should now be performed in order to form a conclusion on any required amendment.

Note: The marks will be split equally between each event.

(Total: 10 marks)

Test your understanding 14 – Written representations

(a) Explain the purpose of a written representation.

(3 marks)

(b) You are the manager in charge of the audit of Crighton-Ward, a public limited liability company which manufactures specialist cars and other motor vehicles for use in films. Audited revenue is $140 million with profit before tax of $7.5 million.

All audit work up to, but not including, obtaining a written representation has been completed. A review of the audit file has disclosed the following outstanding points:

Lion's Roar

The company is facing a potential legal claim from the Lion's Roar company in respect of a defective vehicle that was supplied for one of its films. Lion's Roar maintains that the vehicle built was not strong enough while the directors of Crighton-Ward argue that the specification was not sufficiently detailed. Dropping a vehicle 50 metres into a river and expecting it to continue to remain in working condition would be unusual, but this is what Lion's Roar expected.

Solicitors are unable to determine liability at the present time. A claim for $4 million being the cost of a replacement vehicle and lost production time has been received by Crighton-Ward from Lions' Roar. The directors' opinion is that the claim is not justified.

Depreciation

Depreciation of specialist production equipment has been included in the financial statements at the amount of 10% per annum using the reducing balance method. The treatment is consistent with prior accounting periods (which received an unmodified audit opinion) and other companies in the same industry. Sales of old equipment show negligible profit or loss on sale. The audit senior, who is new to the audit, feels that depreciation is being undercharged in the financial statements.

Required:

(b) Discuss whether or not a paragraph is required in the written representation for each of the above matters.

(4 marks)

(c) A suggested format for the written representation has been sent by the auditor to the directors of Crighton-Ward. The directors have stated that they will not sign the written representation this year on the grounds that they believe the additional evidence that it provides is not required by the auditor.

Required:

Discuss the actions the auditor may take as a result of the decision made by the directors not to sign the written representation.

(3 marks)

(Total: 10 marks)

Test your understanding 15 – Auditors' reports

It is 1 July 20X5. You are reviewing the working papers of several audit assignments recently carried out by your audit firm. Each of the audit engagements is nearing completion and the auditor's reports are due to be issued soon. In each case the year end of the company is 31 March 20X5. The following issues have been brought to your attention.

(a) **Eliud Co** (Profit before tax $150,000)

On 3 April 20X5 a letter was received informing the company that a customer, who owed the company $30,000 as at the year end had been declared bankrupt on 31 March 20X5. At the time of the audit it was expected that unsecured creditors, such as Eliud Co, would receive nothing in respect of this debt. The directors refuse to change the financial statements to provide for the loss, on the grounds that the notification was not received by the statement of financial position date.

Total debts shown in the statement of financial position amounted to $700,000. **(5 marks)**

(b) **Brigid Co** (Profit before tax $500,000)

On 31 May 20X5 a customer sued the company for personal damages arising from a defect in one of its products. Shortly before the year end the company made an out-of-court settlement with the customer of $10,000, although this agreement is not reflected in the financial statements. Further, the matter subsequently became known to the press and was extensively reported. The company's legal advisers have now informed you that further claims have been received following the publicity, although they are unable to place a figure on the potential liability arising. The company has referred to the claims in a note to the financial statements stating that no provision has been made because the claims are not expected to be material. **(5 marks)**

(c) **Kenenisa Co** (Profit before tax $250,000)

The audit work revealed that a trade investment stated in the statement of financial position at $500,000 has suffered a permanent fall in value of $300,000. The directors have refused to recognise an impairment charge in respect of the asset.

(5 marks)

(d) **Mary Co** (Profit before tax $100,000)

Mary Co is a construction company, currently building a warehouse on its own premises and using some of its own workforce. The labour cost has been included in the cost of the non-current asset in the statement of financial position at a value of $10,000. During the audit it was discovered that the direct labour cost records for the early part of the year have been accidentally destroyed.

(5 marks)

Required:

Discuss each of the issues and describe the impact on the auditor's reports, if any, should these issues remain unresolved.

(Total: 20 marks)

Test your understanding 16 – Corporate Governance 1

You are an audit manager of Satsuma & Co and have been assigned to the audit of Tangerine Tech Co (Tangerine), a company which is planning to list on a stock exchange within six months. The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are unsure whether they are following best practice in relation to this. They have asked the audit engagement partner for their view on this matter.

Tangerine's board comprises six executive directors, a non-executive chair and three other non-executive directors (NEDs). The chair and one of the NEDs are former executive directors of Tangerine and on reaching retirement age were asked to take on non-executive roles. The company has established an audit committee, and all NEDs are members including the chair who chairs the committee. All four members of the audit committee were previously involved in sales or production related roles.

All of the directors have been members of the board for at least four years. As the chair does not have an executive role, they have sole responsibility for liaising with the shareholders and answering any of their questions. The company has not established an internal audit function to monitor internal controls.

Required:

Using the information above describe FIVE corporate governance weaknesses faced by Tangerine Tech Co and provide a recommendation to address each weakness to ensure compliance with corporate governance principles.

(10 marks)

Test your understanding 17 – Corporate Governance 2

1 What is meant by corporate governance?

(2 marks)

2 Why are external auditors interested in corporate governance?

(2 marks)

3 Who should make up a typical audit committee?

(1 mark)

4 What is the audit committee's role?

(5 marks)

5 Why does a company need an audit committee if it has a good relationship with its external auditors?

(2 marks)

6 A company has identified one of its major risks as loss of key staff.

Explain:

- **What they should do as a result of this?**
- **How they might reduce or even eliminate the risk?**
- **Why the auditor is interested in this, given that it is not a direct financial risk?**

(3 marks)

(Total: 15 marks)

Test your understanding 18 – Internal audit

Flylo is an airline. The company owns some of its fleet of aircraft. Other aircraft are leased from third parties. Flylo has an internal audit function that has recently been expanded. Your firm is the external auditor of Flylo. Your firm has been asked to investigate the extent to which it may be able to rely on the work of internal audit in the following areas:

- Sales and ticketing
- Fleet acquisition and maintenance
- Trade payables and long-term debt financing (borrowings).

Required:

(a) Explain why the work of the internal auditors, in the three areas noted above, is likely to be useful to you as the external auditor.

(6 marks)

(b) Explain the matters that should be considered by the external auditor when evaluating the internal audit function and whether reliance can be placed on its work.

(4 marks)

(Total: 10 marks)

Test your understanding answers

Test your understanding 1 – Confidentiality

(a) **Disclosure of information without client consent**

The auditor must disclose information which is required by law, for example:

– Production of documents or other provision of evidence in the course of legal proceedings.

– Disclosure to the appropriate public authorities of infringements of the law that come to light e.g. money laundering.

The auditor must disclose information when there is a professional duty or right to disclose, when not prohibited by law:

– To comply with the quality review of ACCA or another professional body.

– To respond to an inquiry or investigation by ACCA or a regulatory body.

– To protect the professional interests of a professional accountant in legal proceedings.

– To comply with technical standards and ethics requirements.

Factors to be considered before disclosing confidential information include:

- Whether harm could be caused by the disclosure
- Whether all relevant information is known and substantiated
- Whether the information is to be communicated to appropriate recipients.

(b) **Response to requests**

– The auditor must not disclose information without the consent of the client or unless the necessary statutory documentation is provided by the person(s) requesting the information.

– Unless the auditor has reason to believe that there is a statutory duty not to inform the client that an approach has been made, the client should first be approached to see if consent can be obtained, and to see if the client is aware of the investigations. The auditor should ensure that the client is aware of the fact the voluntary disclosure may work in the client's favour. If the client refuses, the auditor should inform the client if the auditor has a statutory duty of disclosure.

– Legal advice should be sought in all of the cases described.

– Where the auditor is made aware of potential actions against the client that may have an effect on the financial statements, the auditor must consider the effect on the auditor's report. If the client is aware of the investigation, the auditor will be able to seek audit evidence to support any necessary provisions or disclosures in the financial statements.

– The auditor should consider whether the suspected fraud relating to the managing director relates to the company and affects the financial statements.

– The auditor will be in a very difficult situation if they become aware of an action that may materially affect the financial statements, but where the client is not, and where auditors are under a statutory duty not to inform the client. This situation will not be improved by the resignation of auditors as they may be obliged to make a statement on resignation. Legal advice is essential in such circumstances.

– Tax authorities normally have powers to ask clients to disclose information voluntarily. Such voluntary disclosure is often looked on favourably by the tax authorities and the courts. Tax authorities normally also have statutory powers to demand information from both clients and auditors.

– The power of the police to demand information is sometimes less clear and auditors and clients should take care to ensure that the appropriate authority to disclose is in place. Those sections of the police investigating serious frauds usually have more powers than the general police.

– It is unlikely that trade union representatives have any statutory powers to demand information.

Test your understanding 2 – Ethical threats

Threat	Managing the threat
Mrs Goodall has been the engagement partner for the last seven years. This creates a familiarity threat. Mrs Goodall may be too trusting of or too close to the client to be able to make objective decisions due to this long association.	Mrs Goodall should be rotated from the engagement team. It may be possible to allow Mrs Goodall to continue as engagement partner for one further year in order to safeguard audit quality. Audit committee approval must be obtained in order to allow this and an engagement quality review should be arranged.

There may be the impression of lack of independence as Simon is related to the engagement partner. Simon could be tempted not to identify errors in case this prejudiced his mother's relationship with the client. In addition, if Mrs Goodall reviews Simon's work, she may not review it as thoroughly as the other audit staff due to their relationship.	To demonstrate complete independence, Simon should not be part of any audit or assurance team for which Mrs Goodall is partner.
As long as the audit senior paid a full fee to Pink Co for the investment advice (i.e. it is on normal commercial terms) there is no ethical threat as investment advice is in the normal course of business for Pink Co. However, if the audit senior received a discount on the services or preferential rates, as a benefit of being part of the audit team, this would create a self-interest threat. The audit senior may overlook issues identified during the audit because of the preferential treatment.	The audit team (and other employees of the firm) should be asked not to use the services of Pink Co, or other audit clients unless prior agreement has been obtained from the relevant engagement partner.
The audit team has been offered a day at the horse races at the end of the audit which creates a self-interest threat. Unless the value is trivial and inconsequential, hospitality is not allowed. The fact that the horse race day costs less than the yacht expense is irrelevant. The auditors may feel indebted to the client and therefore overlook issues identified during the audit.	The day out should not be accepted. The rationale for accepting hospitality in previous years should be investigated.
There are outstanding fees creating a self-interest threat. JT & Co may be reluctant to identify misstatements for fear of not getting paid. In addition, outstanding fees may be considered to be a loan. Loans to clients are not permitted.	Payment for work should be arranged before the audit is commenced, or a payment plan agreed.

Test your understanding 3 – Analytical risk assessment

(a) (i) Explanation of analytical procedures

'Analytical procedures' means the evaluation of financial and other information and the review of plausible relationships in that information. The review also includes identifying fluctuations and relationships that do not appear consistent with other relevant information or results.

(ii) Types of analytical procedures

Analytical procedures can be used as:

– Comparison of comparable information to prior periods to identify unusual changes or fluctuations in amounts.

– Comparison of actual or anticipated results of the entity with budgets and/or forecasts, or the expectations of the auditor in order to determine the potential accuracy of those results.

– Comparison to industry information either for the industry as a whole or by comparison to entities of similar size to the client to determine whether key ratios, such as gross profit margin and the receivables collection period, are reasonable.

(iii) Use of analytical procedures

Risk assessment procedures

Analytical procedures are used at the beginning of the audit to help the auditor obtain an understanding of the entity and assess the risk of material misstatement. Audit procedures can then be directed to these risky areas.

Analytical procedures as substantive procedures

Analytical procedures can be used as substantive procedures in determining the risk of material misstatement at the assertion level during work on the statement of profit or loss and statement of financial position.

Analytical procedures in the overall review at the end of the audit

Analytical procedures help the auditor at the end of the audit in forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

(b) **Profit before tax**

Overall, Tribe Co's result has changed from a loss to a profit. Given that revenue has only increased by 17% and that expenses, at least administration expenses, appear low, then there is the possibility that expenditure may be understated.

Revenue – increase 17%

According to the directors, Tribe Co has had a difficult year. Reasons for the increase in revenue must be ascertained as the change does not conform to the directors' comments. It is possible that the industry as a whole has been growing allowing Tribe Co to produce this good result. Alternatively, incorrect revenue recognition may have been applied.

Cost of sales – fall 17%

A fall in cost of sales is unusual given that revenue has increased significantly. This may have been caused by an incorrect inventory valuation and the use of different (cheaper) suppliers which may cause problems with faulty goods in the next year.

Gross profit (GP) – increase 88%

This is a significant increase with the GP% changing from 33% last year to 53% this year. Identifying reasons for this change will need to focus initially on the change in revenue and cost of sales.

Administration – fall 6%

A fall is unusual given that revenue is increasing and so an increase in administration to support those sales would be expected. Expenditure may be understated, or there has been a decrease in the number of administration staff.

Selling and distribution – increase 42%

This increase does not appear to be in line with the increase in revenue as selling and distribution would be expected to increase in line with revenue. There may be misallocation of expenses from administration or the age of Tribe Co's delivery vans is increasing resulting in additional service costs.

Investment income – new this year

This is expected given the cash surplus in the year, although the amount is still very high indicating possible errors in the amount or other income generating assets not disclosed on the statement of financial position extract.

Interest payable – small fall

Given that Tribe Co has a considerable cash surplus this year, continuing to pay interest is surprising. The amount may be overstated.

Reasons for the lack of fall in interest payment e.g. loans that cannot be repaid early, must be determined. If the interest is associated with the overdraft that was in the SOFP last year, this may have only been paid off just before the year end.

Test your understanding 4 – Audit risk

(a) **Audit risks**

Inventory valuation

Smoothbrush supplies 60% of its goods to Homewares at a significantly reduced selling price. Inventory may be overvalued if the net realisable value is lower than cost.

Receivables

Smoothbrush has extended its credit terms to Homewares from one month to four months. There is an increased risk as balances outstanding become older that they may be irrecoverable resulting in overstatement of receivables.

Plant and equipment

The production facility has a large amount of unused plant and equipment. This plant and equipment should be stated at the lower of its carrying amount and recoverable amount, which may be at scrap value depending on its age and condition. Plant and equipment may be overvalued.

Cut-off

Smoothbrush imports goods from South Asia and the paint can be in transit for up to two months. The company accounts for goods when they receive them. Therefore, at the year end only goods that have been received into the warehouse should be included in the inventory balance and a respective payables balance recognised. Cut-off of purchases and inventory may not be accurate.

Inventory system

A new inventory system was introduced in the year. This could result in inventory balances being misstated if the records and new system have not been set up correctly.

Inventory allowance

Smoothbrush previously maintained an inventory allowance of 1%, however, this year it has decided to remove this. Unless all slow-moving/obsolete items are identified at the year end and their value adjusted, there is a risk that the overall value of inventory may be overstated.

Legal action

The company's finance director (FD) has left and is intending to sue Smoothbrush for unfair dismissal. However, the company does not intend to make any provision or disclosure for any potential payment to the FD. Provisions or contingent liability disclosures may not be complete.

Lack of FD

Inherent risk is higher due to the changes in the finance department. The financial controller has been appointed as temporary FD and this lack of experience could result in increased risk of errors arising in the financial statement. In addition, the previous FD is not available to help with the audit.

Perpetual inventory system

Inventory may be misstated if the perpetual inventory counts are not complete and accurate. The inventory counts should cover all of the inventory lines but if any of the warehouses are not counted then this will need to be done at the year end. In addition, inventory adjustments arising from the counts must be verified and updated by an appropriate member of the finance team to ensure the records are accurate.

(b) **Importance of assessing risks**

– Assessing engagement risk at the planning stage will ensure that attention is focused early on the area's most likely to cause material misstatements.

– A thorough risk assessment will also help the auditor to fully understand the entity, which enables an effective audit to be performed. Any unusual transactions or balances would also be identified early, so that these could be addressed in a timely manner.

– As auditors adopt a risk-based audit approach, these risks need to be assessed early in order for the audit strategy and detailed work programmes to be developed.

- Assessing risks early should also result in an efficient audit. The team will only focus their time and effort on key areas as opposed to balances or transactions that might be immaterial or unlikely to contain errors.
- Assessing risk early should ensure that the most appropriate team is selected with more experienced staff allocated to higher risk areas and high risk balances.
- A thorough risk analysis should ultimately reduce the risk of an inappropriate audit opinion being given. The audit would have focused on the main risk areas and hence any material misstatements should have been identified.
- It should enable the auditor to have a good understanding of the risks of fraud, money laundering, etc. Assessing risk should enable the auditor to assess whether the client is a going concern.

(c) **Substantive procedures to confirm valuation of inventory**

- Select a representative sample of goods in inventory at the year end, agree the cost per the records to a recent purchase invoice and ensure that the cost is correctly stated in the inventory records.
- Select a sample of inventory from the inventory listing and review post-year-end sales invoices to ascertain if NRV is above cost or if an adjustment is required.
- For a sample of manufactured items obtain cost sheets and agree:
  - raw material costs to recent purchase invoices
  - labour costs to time sheets or wage records
  - overheads allocated are of a production nature.
- Review aged inventory reports and identify any slow-moving goods. Discuss with management why these items have not been written down.
- Compare the level/value of aged product lines to the total inventory value to assess whether the allowance for slow-moving goods of 1% should be reinstated.
- Review the inventory records to identify the level of adjustments made throughout the year for damaged/obsolete items. If significant, consider whether the year-end records require further adjustments and discuss with management whether any further write downs/allowance may be required.

- Follow up on any damaged/obsolete items noted by the auditor at the inventory counts attended, to ensure that the inventory records have been updated correctly.
- Calculate the average inventory holding period for the current year and compare to prior year. Discuss any significant variations with management.
- Compare the gross margin for current year with prior year. Fluctuations in gross margin could be due to inventory valuation issues. Discuss significant variations in the margin with management.

(d) Substantive procedures to confirm completeness of provisions or contingent liabilities

- Discuss with management the nature of the dispute between Smoothbrush and the former FD, to ensure that a full understanding of the issue is obtained and to assess whether an obligation exists.
- Review any correspondence with the former FD to assess if a reliable estimate of any potential payments can be made.
- Review correspondence with the company's lawyers to obtain their views as to the probability of the FD's claim being successful.
- Review board minutes and any company correspondence to assess whether there is any evidence to support the former FD's claims of unfair dismissal.
- Obtain a written representation from the directors of Smoothbrush confirming their view that the former FD's chances of a successful claim are remote, and hence no provision or contingent liability is required.

Test your understanding 5 – Fraud

(a) **Internal audit function: risk of fraud and error**

Internal audit can help management manage risks in relation to fraud and error, and exercise proper stewardship by:

– Commenting on the process used by management to identify and classify the specific fraud and error risks to which the entity is subject.

– Periodically auditing or reviewing systems or operations to determine whether the risks of fraud and error are being effectively managed.

– Where deficiencies which provide opportunity for fraud and error are identified, making recommendations for improvements.

– Monitoring the incidence of fraud and error and investigating serious cases.

In practice, the work of internal audit often focuses on the adequacy and effectiveness of internal control procedures for the prevention, detection and reporting of fraud and error. Routine internal controls (such as the controls over computer systems and the production of routine financial information) and non-routine controls (such as controls over year-end adjustments to the financial statements) are relevant.

It should be recognised however that many significant frauds bypass normal internal control systems and that in the case of management fraud in particular, much higher-level controls (those relating to the high-level governance of the entity) need to be reviewed by internal audit in order to establish the nature of the risks, and to manage them effectively.

(b) **External auditors: fraud and error in an audit of financial statements**

– External auditors are required by ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* to consider the risks of material misstatements in the financial statements due to fraud. Their audit procedures will then be based on that risk assessment.

– Regardless of the risk assessment, auditors are required to be alert to the possibility of fraud throughout the audit and maintain an attitude of professional scepticism, notwithstanding the auditors' past experience of the honesty and integrity of management and those charged with governance.

- Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud.
- Auditors should make enquiries of management regarding management's assessment of fraud risk, its process for dealing with risk, and its communications with those charged with governance and employees. They should enquire of those charged with governance about the oversight process.
- Auditors should also enquire of management and those charged with governance about any suspected or actual instance of fraud.
- Auditors should consider fraud risk factors, unusual or unexpected relationships, and assess the risk of misstatements due to fraud, identifying any significant risks. Auditors should evaluate the design of relevant internal controls, and determine whether they have been implemented.
- Auditors should determine an overall response to the assessed risk of material misstatements due to fraud and develop appropriate audit procedures, including testing certain journal entries, reviewing estimates for bias, and obtaining an understanding of the business rationale of significant transactions outside the normal course of business.
- Appropriate written representations should be obtained from management confirming they have informed the auditor of all known or suspected frauds.
- External auditors are only concerned with risks that might cause material error in the financial statements. External auditors might therefore pay less attention than internal auditors to small frauds (and errors), although they must always consider whether evidence of single instances of fraud (or error) are indicative of more systematic problems.
- It is accepted that because of the hidden nature of fraud, an audit properly conducted in accordance with ISAs might not detect a material misstatement in the financial statements arising from fraud. In practice, routine errors are much easier to detect than frauds.
- Where auditors encounter suspicions or actual instances of fraud (or error), they must consider the effect on the financial statements, which will usually involve further investigations.
- They should also consider the need to report to management and those charged with governance.

- Where serious frauds (or errors) are encountered, auditors need also to consider the effect on the going concern status of the entity, and the possible need to report externally to third parties, either in the public interest or for regulatory reasons. Many entities in the financial services sector are subject to this type of regulatory reporting and many countries have legislation relating to the reporting of money laundering activities, for example.

(c) **Nature of risks arising from fraud and error: Stone Holidays**

- Stone Holidays is subject to all of the risks of error arising from the use of computer systems. If programmed controls do not operate properly, for example, the information produced may be incomplete or incorrect.
- Inadequate controls also give rise to the risk of fraud by those who understand the system and are able to manipulate it in order to hide the misappropriation of assets, such as receipts from customers.
- All networked systems are also subject to the risk of error because of the possibility of the loss or corruption of data in transit. They are also subject to the risk of fraud where the transmission of data is not securely encrypted.
- All entities that employ staff who handle company assets (such as receipts from customers) are subject to the risk that staff may make mistakes (error) or that they may misappropriate those assets (fraud) and then seek to hide the error or fraud by falsifying the records.
- Stone Holidays is subject to problems arising from the risk of fraud perpetrated by customers using stolen credit or debit cards or even cash. Whilst credit card companies may be liable for such frauds, attempts to use stolen cards can cause considerable inconvenience.
- There is a risk of fraud perpetrated by senior management who might seek to lower the amount of money payable to the central fund (and the company's tax liability) by falsifying the company's sales figures, particularly if a large proportion of holidays are paid for in cash.
- There is a risk that staff may seek to maximise the commission they are paid by entering false transactions into the computer system that are then reversed after the commission has been paid.

Test your understanding 6 – Quality management

Client A

Failure to sign off a working paper makes it difficult to identify the person responsible for the work in case of any query. If the working papers had been reviewed, the reviewer should have identified this issue and investigated who had performed the work and asked them to sign the working papers.

Completion dates of audit work are essential in order to identify the information that would have been available to the auditor at the time the procedures were completed. With the passage of time, more information can come to light which would change the conclusion. If the working papers had been reviewed, the reviewer should have identified this issue and asked the preparer to date the working papers.

Review of the working papers is an important part of quality management. Every team member's work should be reviewed by someone more senior to ensure it has been performed properly and to the appropriate standard. If a review has not been performed there could be material misstatements that have not been detected during the audit which could result in an inappropriate auditor's report being issued.

Client B

The comment on the file stating that there are no matters requiring written representation would indicate that the audit manager does not understand the professional standards that should be followed during an audit, specifically the requirements of ISA 580 *Written Representations*.

Written representations are required by ISA 580. By not obtaining a written representation the audit firm does not have sufficient appropriate evidence to support the audit opinion.

Written representations should include matters such as management confirming they have prepared financial statements that give a true and fair view and that they have provided the auditor with all of the information required for the audit.

The audit partner should not have signed the auditor's report without the written representation being on file.

Client C

A sample of 30 was chosen for a purchases test yet only 27 were tested and a conclusion drawn from those items.

Sample sizes are chosen to ensure sufficient appropriate evidence has been obtained. As only 27 items were tested instead of 30, sufficient appropriate evidence has not been obtained in this instance.

The three missing invoices could be evidence of a wider control deficiency or a material fraud. Further investigation should have been performed to discover the reason for the missing invoices.

The issue may indicate a lack of supervision if the audit team member was unsure how to proceed after discovering the issue.

The issue would also indicate a lack of review as the matter was not identified during the review process.

Client D

Provisions are inherently risky as they are often determined by the judgement of management. As such they should be audited by someone with suitable experience and judgement.

An audit junior should not have performed this task. Tasks should be allocated to team members of appropriate experience and competence. Junior members of staff are usually allocated lower risk areas which require little experience and judgement. More senior members of the team should be assigned the riskier areas of the audit.

It is stated that the audit manager was too busy to perform the audit of the provision due to other client work. This may indicate that the workload of staff is not manageable. Audit quality could have been affected on both clients as work may be rushed to get it completed which may result in material misstatements going undetected.

Client E

Planning is an important and compulsory part of the audit process. ISA 300 *Planning an Audit of Financial Statements* requires the audit to be planned in order to ensure that the audit is performed in an efficient and effective manner and an appropriate audit approach is taken which addresses the risks of the audit.

The auditor should not simply copy last year's procedures and approach as this may not be appropriate for this year's circumstances.

By failing to plan the audit properly, ISA 300 has not been complied with and therefore the audit has not been performed in accordance with professional standards.

General points

The quality issues identified raise doubts over the performance of several audits conducted by the firm.

If it is discovered that an inappropriate auditor's report was issued in any of these cases the firm could face action by the ACCA and by the client.

Any action taken against the firm could damage its reputation as well as result in a loss of clients and financial penalties.

The firm's policies and procedures should be communicated again to staff to remind them of the requirements and their importance.

Further training is recommended to ensure staff are aware of how to comply with the requirements.

Disciplinary action may be necessary in respect of staff who have been found to be deliberately disregarding company policy.

Test your understanding 7 – Controls

	Deficiency (1 mark)	**Recommendation (1 mark)**
1	Hand written orders are not sequentially numbered. Orders could be placed for goods not required resulting in a build-up of inventory which could lead to overstatement of inventory balances and a reduction in profit. Alternatively, orders could be lost and not placed leading to potential stock outs. This will mean customer orders cannot be fulfilled leading to customer dissatisfaction.	Orders should be sequentially pre-numbered. A sequence check should be performed on a regular basis to ensure completeness. Orders should be authorised by a manager before being placed to ensure the goods are required.
2	Purchase orders are not issued for all goods and services. Goods/services could be purchased that are not legitimate (occurrence of purchases). This will increase costs for the company.	Purchase orders should be required for all goods. For services, a budget should be set and quotes obtained. Purchase orders should be authorised by someone other than the person requesting the goods to ensure they are for business use.

3	There is no system for recording receipt of other goods and services. Failure to record goods received could lead to over-ordering as inventory levels will be inaccurate. This will result in additional cost for the company and possible overstatement of inventory due to obsolescence.	A goods received note should be completed and used to update the inventory records on a daily basis.
4	Goods received are not checked against the purchase order. Goods could be received that have not been ordered. Incorrect quantities could be received. This will lead to production delays if the wrong goods have been received and delays in fulfilling customer orders leading to customer dissatisfaction.	Agree the GRN to the purchase order to ensure the correct goods are being delivered.
5	There is no review of the bookkeeper's work e.g. posting of invoices into the general ledger. Errors could go undetected resulting in misstatement of purchases and payables and incorrect payments to suppliers.	A review of the general ledger postings by a manager should be performed on a regular basis.
6	A list of suppliers to be paid is given to the managing director without supporting documentation. The managing director will not know if payables are valid or correct therefore could be paying incorrect amounts resulting in misstatement of payables and poor cash flow management.	The managing director should also review source documents before signing the list to ensure payments are for a valid business use.
7	There is a lack of segregation of duties as the managing director authorises invoices, approves payment and signs cheques. Fraud could occur and go undetected as the managing director could create a fictitious purchase invoice to support a payment to him or herself. This will cause loss for the company.	Segregate duties by sharing the responsibility with another manager.

Test your understanding 8 – Inventory count

(a) **Procedures prior to inventory count attendance**

- Review prior year working papers to identify any issues encountered which the auditor should be prepared for this year.
- Obtain inventory count instructions from the client to ascertain whether appropriate controls and procedures will be in place during the count.
- Enquire with management whether there have been any control issues relating to inventory during the year.
- Enquire of the client whether any inventory is held at third parties and assess whether attendance is required at those sites.

(b) **Deficiencies in counting inventory**

Deficiency	**How to overcome deficiency**
Inventory sheets stated the quantity of items expected to be found in the store. Count teams will focus on finding that number of items making undercounting of inventory more likely – teams may stop counting when 'correct' number of items found.	Count sheets should not state the quantity of items so as not to pre-judge how many units will be found.
Count staff were all drawn from the stores. Count staff are also responsible for the inventory. There could be a temptation to hide errors or missing inventory that they have removed from the store illegally resulting in misstatement of the inventory balance.	Count teams should include staff who are not responsible for inventory to provide independence in the count.
Count teams are allowed to decide which areas to count. There is a danger that teams will either omit inventory from the count or even count inventory twice due to lack of precise instructions on where to count. This will result in either under or overstatement of inventory.	Each team should be given a precise area of the store to count.

Count sheets were not signed by the staff carrying out the count. Lack of signature makes it difficult to raise queries regarding items counted because the actual staff carrying out the count are not known.	All count sheets should be signed to confirm who actually carried out the count of individual items.
Inventory is not marked to indicate it has been counted. As above, there is a danger that inventory will be either omitted or included twice in the count resulting in either under or overstatement of inventory.	Inventory should be marked in some way to show that it has been counted to avoid this error.
Recording information on the count sheets in pencil. Recording in pencil means that the count sheets could be amended after the count has taken place, not just during the count. The inventory balances will then be incorrectly recorded.	Count sheets should be completed in ink.
Count sheets for inventory not on the pre-numbered count sheets were only numbered when used. Additional inventory sheets could be lost as there is no control of the sheets actually being used. Sheets may not be numbered by the teams, again giving rise to the possibility of loss and understatement of inventory.	All inventory sheets, including those for 'extra' inventory, should be pre-numbered.

(c) **Tests of controls and substantive procedures**

The aim of a test of control is to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level.

Example: Observe the count teams to ensure they are counting in accordance with the client's inventory count instructions.

The aim of a substantive procedure is to ensure that there are no material errors at the assertion level in the client's financial statements.

Example: Record the condition of items of inventory to ensure that the valuation is appropriate on the final inventory listing.

Test your understanding 9 – Evidence and procedures

Audit procedures

(i) **Analytical procedures** consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Inquiry means to seek relevant information from sources, both financial and non-financial, either inside or outside the company being audited. Evidence may be obtained orally or in writing.

Inspection is the examination of records, documents and tangible assets.

Observation involves looking at a process or procedure as it is being performed to ensure that the process actually works as documented.

Recalculation means the checking of the mathematical accuracy of documents or records.

(ii) **Analytical procedures**

Compare revenue year on year to try to identify whether income has been understated, possibly by cash being stolen prior to banking. There is no control over the opening of post so cash could be withdrawn by one assistant, and the deficit made up by a fraud on customers.

Inquiry

Obtain statements from suppliers to check the completeness of liabilities at the end of the year. As there is no control over purchases, invoices could have been misplaced resulting in lower purchases and trade payables figures.

Inspection

The assets of the company, namely cuddly toys in inventory at the end of the year, can be inspected to ensure the inventory exists and that the toys are saleable in their current condition.

Observation

Procedures such as the opening of the post and recording of customer orders can be observed to ensure that all orders are recorded in the detailed sales listing and bank ledger account.

Recalculation

Recalculating the bank ledger account to confirm that the total amount of cash recorded is accurate and can be included in the revenue figure (cash receipts should equal revenue as there are no receivables).

(iii) **Analytical procedures**

This method of collecting evidence will be useful in BearsWorld because it will help to identify unusual changes in income and expenditure. As BearsWorld is a relatively small company, monitoring gross profit will show relatively small changes in sales margin or purchasing costs. Decisions by Azariah to amend margins can therefore be traced into the actual sales made.

Enquiry

Enquiry evidence will be very useful in the audit of BearsWorld, especially where this is derived from third parties. Third party evidence is generally more reliable than client originated evidence as there is a decreased likelihood of bias. Trade payables can therefore be verified using supplier statement reconciliations. A review of any customer complaints file (if these letters are kept) will also help to identify any orders that have not been despatched.

Inspection

Inspection of documents within BearsWorld will be useful, particularly regarding checking whether expenses are bona fide. All purchase invoices, for example, should be addressed to BearsWorld and relate to purchases expected from that company, e.g. cuddly toys for resale, office expenses, etc.

Observation

Observation may be useful because it will show how the assistants perform their work and whether there are any obvious deficiencies in the processes of the company.

Recalculation

Recalculation evidence is very useful for checking additions on invoices, balancing of control accounts, etc. This means that the arithmetical accuracy of the books and records in BearsWorld can be confirmed.

(iv) **Analytical procedures**

The technique may be limited in its application because it will not detect errors or omissions made consistently year on year. If either assistant is defrauding the company (for example by removing cash) each year, then analytical procedures will not detect this. Analytical procedures will also not detect misstatements which cancel each other out, i.e. one misstatement may overstate the balance but another may understate the balance. The auditor would not detect these misstatements using analytical procedures.

Enquiry

External inquiry evidence will be less useful in the audit of sales and receivables because there are no receivables as goods are paid for prior to despatch. Internal evidence will be available from Azariah and the assistant, however the lack of segregation of duties means that this may not be so reliable.

Inspection

Inspection of documents can be time consuming. However, given the poor internal control system within BearsWorld, the auditor may have no choice but to use this method of gathering evidence.

The fact that an invoice is addressed to the company does not confirm completeness of recording so inspection of the bank ledger account for unusual payments verified by checking the purchase invoice will also be required. Additional substantive testing would also be required due to poor controls.

Observation

Observation tests will be of limited usefulness because the assistants may act differently when an auditor is present. The same problem will apply to any observations carried out by Azariah.

Recalculation

The main weakness of recalculation checking is that calculations can only be carried out on figures that have been recorded. If there are any omissions then checks cannot be carried out.

Test your understanding 10 – Procedures

Inspection

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Inspect the bank reconciliation for any outstanding lodgements and agree to the pre-year-end bank ledger account, post-year-end bank statement and also to pre-year-end paying-in-book.

Observation

Observation consists of looking at a process or procedure being performed by others.

Observe the process for the opening of mail and logging of any cheques received from customers to ensure adequate segregation of duties.

Analytical procedures

Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships which are inconsistent with other relevant information or which differ from expected values by a significant amount.

Review the year-end bank balance against prior year to identify any significant fluctuations as these could be evidence of window dressing and discuss with management.

Inquiry

Inquiry consists of seeking information from knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

Inquire of management as to whether the company has opened/closed any bank accounts during the period.

Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Recalculate the additions in the bank ledger account to confirm accuracy of the amount.

External confirmation

An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party, in paper form, electronic form or by other medium.

Obtain a standard bank confirmation from each bank the company has undertaken banking transactions with during the year.

Re-performance

Re-performance involves the auditor's independent execution of procedures or controls which were originally performed as part of the entity's internal control.

Re-perform the year-end bank reconciliation to ensure the process was undertaken accurately.

Test your understanding 11 – Audit risk NFP

(a) **Audit risk**

Audit risk is the risk that an auditor gives an inappropriate opinion on the financial statements being audited.

Inherent risk is the susceptibility of an assertion to a misstatement that could be material individually or when aggregated with misstatements, before considering any related controls.

Control risk is the risk that a material misstatement could occur in an assertion that could be material, individually or when aggregated with other misstatements, and will not be prevented or detected on a timely basis by the company's controls.

Detection risk is the risk that the auditors' procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

(b)

Audit risk	Auditor's response
Income is from voluntary donations only. It will be difficult to estimate future income. There is a risk that disclosure of going concern issues is not adequate in the financial statements.	Review forecasts and enquire with the trustees and management of the charity about their fundraising plans for the future. Obtain written representation from the trustees that they believe the charity can continue in existence for the foreseeable future.
Risk to completeness of income as cash donations may be stolen in the absence of any controls. No invoices will be raised and therefore there will be no evidence of the income received.	Assess what controls exist over cash donations (if any). Test the effectiveness of the controls in place. There may need to be a modified opinion due to lack of sufficient appropriate evidence.
There is a risk that the funds are not spent in accordance with the aims of the charity (regularity audit).	Inspect the constitution of the charity to understand its aims. Review a breakdown of expenditure to ensure it is in line with the constitution.
The taxation rules are quite complex for the charity resulting in a risk to the reasonableness of the tax accrual at the year end.	Consult with a tax expert or audit staff with relevant knowledge to assess the tax rules and recalculate the tax charge and liability to ensure arithmetical accuracy.
According to the constitution of the charity, only 10% of expenditure can be on administration. There is a risk that administration costs are deliberately misstated to ensure this restriction is met.	Inspect the constitution of the charity to understand its aims. Review the breakdown of other types of expenditure to identify any admin costs incorrectly classified if the 10% limit has been exceeded.
Some donations are made for an intended purpose. There is a risk that these restricted funds are not disclosed as such in the financial statements.	Obtain supporting documentation for any donations and agree the expenditure to the terms of the donation. Any discrepancies should be reported to management.

(c) **Weak control environment**

Lack of segregation of duties

There is normally a limited number of staff working in the charity meaning that a full system of internal control including segregation of duties cannot be implemented.

Volunteer staff

Many staff are volunteers and so will only work at the charity on an occasional basis. Controls will be performed by different staff on different days making the system potentially unreliable.

Lack of qualified staff

As staff are mainly volunteers they may not have professional qualifications or experience to implement or maintain good control systems.

No internal audit department

Any control system will not be monitored effectively, mainly due to the lack of any internal audit department. The charity will not have the funds or experience to establish internal audit.

Attitude of the trustees

Where trustees are not professionally trained or have little time to devote to the charity, there may be a perception that controls are not important. The overall control environment may therefore be weak as other charity workers may not appreciate the importance of maintaining good controls.

Test your understanding 12 – NFP audit

(a) **Audit risks**

- Charities can be viewed as inherently risky because they are often managed by non-professionals and are susceptible to fraud, although many charities and the volunteers that run them are people of the highest integrity who take a great deal of care over their work.
- Charities are also at risk of being in violation of their constitutions, which is important where funds are raised from public or private donors who may object strongly if funds are not used in the manner expected. Other charities and regulatory bodies supervising charities may also object.

- Most small charities have a high level of control risk because formal internal controls are expensive and are not often in place. This means that donations may be susceptible to misappropriation. Charities have to rely on the trustworthiness of volunteers.
- Ajio is a new client and as a result detection risk is higher due to a lack of cumulative knowledge and experience.

(b) **Audit procedures: fundraising events**

- Attend a fundraising event and observe the procedures employed in collecting, counting, banking and recording the cash. This will help provide audit evidence that funds have not been misappropriated and that all income from such events has been recorded. Sealed boxes or tins that are opened in the presence of two volunteers are often used for these purposes.
- Perform cash counts at the events to provide evidence that cash has been counted correctly and that there is no collusion between volunteers to misappropriate funds.
- Examine bank paying-in slips, bank statements and bank reconciliations and ensure that these agree with records made at events. This also provides evidence as to the completeness of income.
- Examine the records of expenditure for fundraising events (hire of equipment, entertainers, purchase of refreshments, etc.) and ensure that these have been properly authorised (where appropriate) and that receipts have been obtained for all expenditure. This provides evidence as to the completeness and accuracy of expenditure.
- Review the income and expenditure of fundraising events against any budgets that have been prepared and investigate any significant discrepancies.
- Ensure that all necessary licences (such as public entertainment licences) have been obtained by the trustees for such events in order to ensure that no action is likely to be taken against the charity or volunteers.
- Obtain written representation from the trustees to the effect that there are no outstanding unrecorded liabilities for such events for completeness of expenditure and liabilities.

Test your understanding 13 – Subsequent events

Event 1 – Fire

This event occurred after the reporting period and is not an event which provides evidence of a condition at the year end and hence this is a non-adjusting event.

As the company is insured, only uninsured losses suffered by Grains 4U Co (Grains) will need to be accounted for, which in the normal course of events is likely to be an immaterial amount. However, the insurance company is investigating, as there is a possibility the fire was started deliberately, and this will invalidate the insurance policy.

If this is the case, the total damaged assets of $675,000 (650 + 25) would be material as they represent 8.5% (675/7,900) of profit before tax.

Therefore, as a material non-adjusting event, the assets should not be written down to their scrap value in the current year financial statements. However, the directors should include a disclosure note detailing the fire and the total value of assets which may be impacted due to the possibility of a lack of an insurance settlement.

Procedures

- Obtain a schedule showing the damaged property, plant and equipment and agree the carrying amount to the non-current asset register to confirm the total value of affected assets.
- Obtain a breakdown of the inventory stored at the distribution centre on 15 May 20X5 and compare to earlier records or despatch documents to ascertain the likely level of inventory at the time of the fire.
- Review any correspondence from the insurance company confirming the amount of the claim, and the current status of their investigation into the fire and any likely payments to assess the extent of any uninsured amounts.
- Discuss with the directors whether they will disclose the effect of the fire in the financial statements.

Event 2 – Inventory

Grains has identified that inventory at the year end with a cost of $915,000 is defective. This information was obtained after the year end but provides further evidence of the net realisable value of inventory at the year end and hence is an adjusting event.

The inventory of $915,000 must be written down to its net realisable value of $50,000.

The write down of $865,000 (915 – 50) is material as it represents 10.9% (865/7,900) of profit before tax.

Hence, the directors should amend the financial statements by writing down the inventory to $50,000.

Procedures

- Discuss the matter with the directors and enquire if they are prepared to write down the cost of the inventory to net realisable value.
- Review the board minutes to assess whether this event was the only case of defective inventory as there could potentially be other inventory which requires writing down.
- Obtain a schedule showing the defective inventory and agree to supporting production documentation that it was produced prior to 31 March, otherwise it will not require a write down at the year end.
- Discuss with management how they have assessed the scrap value of $50,000 and agree this amount to any supporting documentation to confirm the value.

Test your understanding 14 – Written representations

(a) Written representations are a form of audit evidence. They are written by the company's directors and sent to the auditor, just before the auditor's report is signed.

Written representations are required for two reasons:

- For the directors to acknowledge their collective responsibility for the preparation of the financial statements and to confirm that they have approved those statements.
- To confirm any matters which are material to the financial statements where representations are crucial to obtaining sufficient and appropriate audit evidence.

In the latter situation, other forms of audit evidence are normally limited because knowledge of the facts is confined to management and the matter is one of judgement or opinion.

Obtaining written representations does not mean that other evidence does not have to be obtained. Audit evidence will still be collected and the representation will support that evidence. Any contradiction between sources of evidence should be investigated.

(b) **Lion's Roar**

It is appropriate to include the claim in the written representation.

The amount of the claim is material being 50% of profit before tax.

There is also a lack of definitive supporting evidence for the claim. The two main pieces of evidence available are the claim from Lion's Roar itself and the legal advice from Crighton Ward's solicitors. However, any claim amount cannot be accurately determined because the dispute has not been settled.

The directors have stated that they believe the claim not to be justified, which is one possible outcome of the dispute. However, in order to obtain sufficient evidence to show how the treatment of the potential claim was decided for the financial statements, the auditor must obtain this opinion in writing.

Depreciation

Including the point in the written representation is inappropriate because the auditor appears to have obtained sufficient evidence to confirm the accounting treatment.

The lack of profit or loss on sale confirms that the depreciation charge is appropriate. Large profits would indicate over-depreciation and large losses would indicate under-depreciation. The amount also meets industry standards which suggests that Crighton-Ward's accounting policy is acceptable.

(c) Lack of written representation

- Discuss the situation with the directors to try and resolve the issue that the directors have raised. Ascertain exact reasons why the directors will not sign the letter.
- Explain the need for the written representation again and note that the requirement to obtain a written representation letter was included in the engagement letter.
- Consider whether amendments can be made to the letter to incorporate the directors' concerns that will still provide the auditor with appropriate and sufficient audit evidence.
- Explain that if the auditor does not receive sufficient and appropriate audit evidence, then the audit opinion will have to be modified due to an inability to obtain sufficient appropriate evidence.

Test your understanding 15 – Auditor's report

(a) **Eliud Co**

The receivable of $30,000 represents 20% of profit and more than 4% of receivables therefore is material.

The bankruptcy of the customer provides evidence of a condition existing at the statement of financial position date. It should therefore be treated as an adjusting event in accordance with IAS 10 *Events After the Reporting Period.* The receivable should be written off in full in the financial statements at 31 March 20X5.

The company has overstated receivables and profit by $30,000.

Impact on the auditor's report

- The financial statements are materially misstated.
- The matter is material but not pervasive.
- A qualified opinion should be issued with the 'except for' wording.
- The 'Basis for Opinion' section will be amended to a 'Basis for Qualified Opinion' to explain the reason for the qualified opinion.

(b) **Brigid Co**

The amount of $10,000 represents only 2% of the stated profit before tax and therefore is not material.

The potential losses may be more significant than the figure of $10,000 since other claims are now pending. The auditor may conclude that the whole legal matter is potentially material.

There is uncertainty with regard to the outcome of the pending claims and the potential liability which may arise as a result of the product defect. The appropriate accounting treatment will depend on whether the chance of loss is probable, possible or remote. If it is probable a provision should be recognised. If it is possible a contingent liability should be disclosed. If it is remote the financial statements will not be affected. (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

Liabilities may be understated or contingent liabilities may not be adequately disclosed.

Impact on the auditor's report

- Management has chosen to ignore both the actual loss (which is not individually material) and the potential loss (which may be material). If the auditor does not believe that the management's view is acceptable, or does not think that the disclosure is adequate, the financial statements will be materially misstated.

- If the potential claims are still considered immaterial, the opinion will be unmodified stating that the financial statements give a true and fair view.
- If the potential claims are considered material, a qualified opinion with the 'except for' wording should be issued.
- If the auditor believes that the claims are likely to be successful and are likely to be substantial then an adverse opinion should be issued stating that the financial statements do not show a true and fair view.
- The 'Basis for Opinion' section will be amended to a 'Basis for Qualified Opinion' or 'Basis for Adverse Opinion' to explain the reason for the modified opinion.

(c) **Kenenisa Co**

The fall in value is material and pervasive as the adjustment would have the effect of turning a profit before tax of $250,000 into a loss of $50,000.

Investments should be written down if they are impaired. A fall in the value of one asset must not be offset against an increase in the value of another asset. Each asset has to be considered separately.

As the company admits that a permanent fall in value has taken place it should write the value of the assets down otherwise assets will be overstated.

Impact on the auditor's report

- The financial statements are materially misstated.
- The matter is material and pervasive.
- An adverse opinion should be issued stating that the financial statements do not show a true and fair view.
- The 'Basis for Opinion' section will be amended to a 'Basis for Adverse Opinion' to explain the reason for the adverse opinion.

(d) **Mary Co**

The $10,000 represents 10% of profit before tax, and so would appear to be material.

Since the accounting records were only destroyed for the early part of the year, the auditor would still be able to confirm the calculations for the later part of the year. In these particular circumstances the auditor may consider that the amount of any error (which is likely to be considerably less than $10,000) is not material.

The company must include the cost of its own labour and materials in the construction of the warehouse, since these have been used to create a non-current asset.

Impact on the auditor's report

– There is a lack of sufficient appropriate evidence to support the treatment of the $10,000 labour costs therefore the auditor does not know whether the costs are materially misstated.

– Assuming that the extent of any potential misstatement is considered not material, an unmodified opinion will be issued stating that the financial statements give a true and fair view.

– If the possible misstatement is considered material, a qualified opinion with the 'except for' wording will be required.

– If modified, the 'Basis for Opinion' section will be amended to a 'Basis for Qualified Opinion' to explain the reason for the qualified opinion.

Tutorial note: If any of the companies were listed, the Key Audit Matters section would reference the Basis for Qualified Opinion.

Test your understanding 16 – Corporate governance 1

The board comprises six executives and only three non-executive directors (NEDs), excluding the chair. There should be an appropriate balance of executives and NEDs, to ensure that the board makes the correct objective decisions, which are in the best interest of the stakeholders of the company, and no individual or group of individuals dominates the board's decision-making.	At least half of the board, excluding the chair, should be NEDs. Hence the board of Tangerine Tech Co (Tangerine) should consider recruiting and appointing additional independent NEDs to satisfy this requirement.
One of the NEDs and the chair are former executive directors of Tangerine who were asked to take on their existing roles following retirement. As former executive directors, they were previously employed by the company and so will not bring the required level of independence and objective judgement to the role as is necessary. The independence of the other NEDs cannot be assessed.	Independent non-executives with relevant experience and skills should be appointed to the board of Tangerine. A review should be under taken of the independence of all existing NEDs. Any who are not independent should ideally be replaced or supplemented by independent NEDs. The board chair must be independent on appointment therefore must be replaced.

The board chair, who is a NED, also has the role of audit committee chair. The chair of the board should not be a member of the audit committee as this will compromise the independence of the audit committee and give too much power to the board chair.	The board chair should cease to be a member of audit committee. One of the newly appointed independent NEDs should be appointed as audit committee chair.
All four members of the audit committee were previously involved in sales or production related roles. At least one member of the audit committee should have recent and relevant financial experience. None of the NEDs were former finance directors and so it is unlikely they possess the required financial experience.	The company should ensure when they recruit the new independent NEDs that at least one of them has the required recent and relevant financial experience.
All of the directors have been members of the board for at least four years. The shareholders should review on a regular basis that the composition of the board of directors is appropriate, and that there is an appropriate re-election process in place to ensure this can be achieved.	The directors should be subject to re-election annually by the shareholders. At the current year's annual general meeting it should be proposed that the directors are subject to re-election.
The chair has sole responsibility for liaising with the shareholders and answering any of their questions. However, this is a role which the board as a whole should undertake.	All members of the board should be involved in ensuring that satisfactory dialogue occurs with shareholders, for example, all should attend meetings with shareholders such as the annual general meeting. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company.

Currently Tangerine has not established an internal audit function. The audit committee should consider the effectiveness of internal controls and internal audit could support this role. Where there is no internal audit function, the audit committee is required to consider annually the need for one.	Further consideration should be given to establishing an internal audit function. Having an internal audit function will help the audit committee to discharge their responsibility for monitoring internal controls. However, the costs of establishing an internal audit function should be considered against the benefits.

Test your understanding 17 – Corporate governance 2

1 **Corporate governance definition**

The term corporate governance refers to the means by which a company is directed and controlled in the interests of all stakeholders. It will include consideration of:

– Directors' responsibilities

– Composition of the board of directors

– Audit requirements (internal and external).

2 **External auditors and corporate governance**

If a company has good standards of corporate governance and is managed well in the interests of all stakeholders, the auditors are likely to conclude that control risk is lower and therefore audit risk is reduced. As a result of this they may be able to reduce the extent of the audit procedures they carry out.

The audit committee should take responsibility for ensuring the external auditor is independent and for monitoring and assessing the quality and effectiveness of the external audit.

The external auditor may have to report on whether the company is compliant with corporate governance requirements.

3 **Composition of the audit committee**

The audit committee should be made up of independent non-executive directors and include at least one person with recent and relevant financial experience.

4 **Role of the audit committee**

– Monitoring the integrity of the financial statements.

– Reviewing the company's internal financial controls.

– Monitoring and reviewing the effectiveness of the internal audit function.

- If no internal audit function is in place, they should consider annually whether there is a need for one and make a recommendation to the board. The reasons for there being no internal audit function should be explained in the annual report.
- Making recommendations in relation to the appointment and removal of the external auditor and their remuneration.
- Reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process.
- Developing and implementing policy on the engagement of the external auditor to supply non-audit services.

5 **Need for an audit committee**

The existence of an audit committee will enhance the company's corporate governance profile by:

- Improving public confidence
- Providing further support to directors
- Strengthening the independence of the external auditor
- Improving internal controls.

6 **Risk management**

The risk committee should discuss the issue and assess its seriousness in relation to its likelihood and potential impact. They should then decide what action is appropriate in order to manage the risk.

This risk might be reduced by:

- Ensuring favourable employment packages for such individuals
- Ensuring training for other staff assists in case of succession issues
- Ensure key tasks are not carried out by just one person.

Loss of key staff may impact the control environment and increase control risk, particularly if duties are no longer segregated.

The auditor must consider the possible impact of all significant risks as any of these could ultimately have financial consequences or going concern issues, hence impacting the audit opinion.

Test your understanding 18 – Internal audit

(a) **Use of the work of the internal auditors by external auditors**

Sales and ticketing

– The sales function is likely to be integrated with the accounting and internal control system used to produce the revenue figure in the financial statements on which the external auditor reports and is therefore useful.

– The internal auditors' work on the ticketing system relates to an operational area which does not have a direct impact on the financial statements. Ticketing may have an indirect effect because it is likely to be integrated with the sales system and there is likely to be some crossover between the controls over ticketing and controls over sales generally. The work of the internal auditors is therefore likely to be of some use to the external auditor.

Fleet acquisition and maintenance

– The internal auditors' work on the fleet acquisition system is likely to be relevant to the external auditor because owned aircraft and leased aircraft will constitute a substantial element of statement of financial position assets and liabilities. The related depreciation and finance charges will be included in the statement of profit or loss.

– Much of the internal auditors' work is likely to relate to ensuring that company policy has been complied with. Company policy will relate to the authorisation for, and acquisition of, aircraft and ensuring the appropriate accounting treatment is being used. The external auditor will want to ensure that the company's policies are both appropriate and complied with.

– It is also possible that the internal auditors' work may involve some verification of the statement of profit and loss and statement of financial position figures. Given the likely materiality of the amounts involved, this work will also be of interest to the external auditor.

– It is possible that the internal auditors' work may also relate to the quality of aircraft, and other operational aspects of fleet management. These issues may also be relevant to the external auditor as they relate to compliance with laws and regulations.

- Maintenance expenditure in the statement of profit or loss may be material and the work of the internal auditors is therefore of interest to external auditors. The internal auditors' work is likely to relate to the authorisation and correct accounting for maintenance expenditure (capitalisation or expensing) which will affect the financial statements.

Trade payables and long-term debt financing

- The extent of the external auditor's interest in the internal auditors' work on trade payables and long-term financing will depend on the materiality of the amounts involved. Trade payables (for certain types of routine maintenance, and payables due to the service organisations, for example) may be material. Long term debt financing is very likely to be material as many airlines have substantial debt financing.
- Internal audit work on trade payables is likely to involve ensuring that routine internal controls are properly designed and are operating effectively. This will be relevant to the external auditor.
- There are substantial financial statement disclosures required for debt financing. The internal auditors' assistance with ensuring that disclosures are properly made, as well as with ensuring that any covenants have been complied with and that the accounting for the financing is appropriate, may also be helpful to the external auditor.

(b) **Evaluating the internal audit function**

- The firm will seek to ensure that there is an appropriate structure within the department itself, with appropriate reporting lines outside of the department, preferably reporting into the audit committee.
- The internal audit function has recently been expanded and there are likely to be changes in the way it is organised. The function should have operational independence within the organisation and formal terms of reference that encompass the recent changes made.
- The function should have a systematic and disciplined approach to its work including quality control procedures.
- Staff should be appropriately trained, experienced and qualified. The head of the internal audit department should preferably be professionally qualified.

Chapter

17

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